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AICPA
American Institute of Certified Public Accountants

INDUSTRY AUDIT GUIDE

AUDITS OF INVESTMENT COMPANIES

PREPARED BY THE COMMITTEE ON INVESTMENT COMPANIES

Including
STATEMENTS OF POSITION
ISSUED BY THE ACCOUNTING STANDARDS DIVISION

Note: This volume includes both the industry audit guide, *Audits of Investment Companies*, as it was originally published in 1973 and Statements of Position No. 74-11 (December 10, 1974) and No. 77-1 (April 15, 1977), issued by the Accounting Standards Division. In using the guide, readers should refer to the additional material in the Statements of Position (see pages 157-186), which were not available when the guide was issued.

Thomas P. Kelley, *Director*
Auditing Standards

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American Institute of Certified Public Accountants
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NOTICE TO READERS

This audit guide is published for the guidance of members of the Institute in examining and reporting on financial statements of investment companies. It represents the considered opinion of the Committee on Investment Companies and as such contains the best thought of the profession as to the best practices in this area of financial reporting. Members should be aware that they may be called upon to justify departures from the Committee's recommendations.

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Additional copies of this booklet may be purchased from the American Institute of CPAs.

AUDITS OF INVESTMENT COMPANIES

Prepared by the Committee on
Investment Companies
American Institute of Certified Public Accountants

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Preface

Applicability

This audit guide has been prepared to assist the independent auditor in examining and reporting on financial statements of investment companies by describing those operating conditions and auditing procedures unique to the industry and by illustrating the form and content of investment company financial statements and informative disclosures pertaining thereto. Chapter 1 discusses the types of companies considered to be investment companies and to whom the procedures in this guide are applicable. The American Institute of Certified Public Accountants published Case Studies in Auditing Procedure No. 6, "A Management Investment Company of the Open-End Type," in 1949. Information contained in that case study is superseded by this guide.

Because so many investment companies are subject to regulation under the Investment Company Act of 1940, rules under that Act are given extensive coverage in this guide. However, changes in the rules, regulations, practices, and procedures of the investment company industry have been frequent and extensive in recent years. *Further changes are under consideration as this guide goes to press and it is imperative that the independent auditor keep abreast of these changes.*

Changes in Accounting and Reporting Practices

The accounting and reporting practices covered by this guide are different in some circumstances from those presently being followed by some investment companies, and are therefore at variance with some practices which, to date, have been generally accepted in the industry. Major changes in accounting and reporting practices which may be required as a result of the publication of this guide are summarized as follows:

1. Requirement that investment securities be carried at value. In the past, only open-end companies (mutual funds) have had this requirement, although many other companies have followed the value practice voluntarily. The option to carry these securities at cost is not available under this guide (Chapter 2).
2. Presentation of realized and unrealized gain (loss) on security transactions (and the combined total thereof) as an integral part of a Statement of Operations, which replaces the Statement of Income (Chapter 7).
3. Acceptability of a Statement of Net Assets in lieu of a Balance Sheet or Statement of Assets and Liabilities (Chapter 7).
4. Presentation of a Statement of Changes in Net Assets for two years (Chapter 7).
5. Presentation of Supplementary Information concerning per-share data and other pertinent operating statistics (Chapter 7).
6. Revision of the wording of the auditor's report in several situations, including reporting on internal accounting controls in Form N-1R (Chapter 8).
7. Recommendation by the Committee for continued experimentation for improving the way in which the most meaningful financial and operational information can be presented to the investor (Chapter 2).

The Accounting Principles Board previously has indicated approval of a statement that the basic postulates and the broad principles of accounting comprehended in the term *generally accepted accounting principles* pertain to business enterprises in general, and these enterprises include investment companies.

While this guide contains certain suggested auditing procedures, detailed audit programs and internal control questionnaires have not been included herein. The guide does not describe all of the auditing procedures necessary to perform an examination in accordance with generally accepted auditing standards. This publication is only a guide in determining the scope of the work for each individual audit. It is not intended to limit or supplant individual judgment, initiative, imagination, and vigilance. Programs for each audit should be designed to meet the requirements of the particular situation, giving careful consideration to the size and type of organization and the adequacy of internal control; this is a matter which can be determined only by the exercise of professional judgment in the light of circumstances present in a particular case.

Effective Date

As mentioned previously, the accounting and reporting practices recommended in the guide differ, in some instances, from those presently followed by all or some parts of the industry. Accordingly, it is the considered opinion of the Committee that, for fiscal periods beginning after December 31, 1973, the financial statements of investment companies, as defined in Chapter 1, should conform to the recommended accounting and reporting practices as set forth herein. Earlier adoption of the recommendations is encouraged.

Implementation

The effect of accounting changes resulting from the implementation of this audit guide should be reported as prior period adjustments, which, as stated in paragraph 18 of APB Opinion No. 9, "Reporting the Results of Operations,"

> . . . should, in single period statements, be reflected as adjustments of the opening balance of retained earnings. When comparative statements are presented, corresponding adjustments should be made of the amounts of net income (and the components thereof) . . . for all of the periods reported therein, to reflect the retroactive application of the prior period adjustments.

Initial recognition of unrealized appreciation on investment securities, for instance, would result in the creation of a new "surplus" account at the "opening" date and the reporting of changes therein for all periods being reported upon.

Acknowledgments

The Committee on Investment Companies has worked closely with committees of the Investment Company Institute and of the National Association of Small Business Investment Companies and has had the benefit of comments from many individuals in the industry and on the staffs of the Securities and Exchange Commission and the Small Business Administration. The Committee wishes to express its sincere appreciation for the significant contributions made by these committees and individuals in the preparation of this audit guide.

Committee on Investment Companies

September 1973

Chapter I

The Investment Company Industry

The business of an investment company consists of selling its capital shares to the public, investing the proceeds—for the most part in securities—in a manner seeking to achieve its announced investment objectives, and distributing to its shareholders the net income from, and the net gains realized on sales of, its investments. Generally, an investment company can be said to be a pooling of funds by shareholders to avail themselves of professional investment management.

Types of Investment Companies

Within the umbrella of the above general definition fall many forms of investment companies, including management investment companies, face-amount certificate companies, unit investment trusts, collective trust funds, investment partnerships, and "offshore funds."[1] Management investment companies include both open-end (mutual funds) and closed-end companies and exchange, dual purpose, hedge, and other special purpose funds, venture capital investment companies, and small business investment companies (SBICs).

[1] See Glossary for these and other specialized terms.

This guide has been written primarily for the guidance of auditors of mutual funds and closed-end companies registered with the Securities and Exchange Commission (the Commission) under the Investment Company Act of 1940, as amended[2] (the 1940 Act), although the accounting principles and auditing procedures set forth herein apply in general to all investment companies investing in securities.

It should be noted that, while venture capital companies (including SBICs) vary in many respects from other investment companies, the provisions of this guide generally apply. For a more detailed discussion of venture capital companies, see Appendix E.

Although separate accounts of life insurance companies funding variable annuity contracts which are registered under the Investment Company Act of 1940 are not specifically covered by this guide, the auditor of such accounts should find the discussions herein informative and helpful, especially the discussion on valuation of securities in Chapter 3. In addition, the auditor should be familiar with accounting practices in general use within the life insurance industry.[3]

History

In 1868, the concept of investment companies arose in England when the Foreign and Colonial Government Trust was formed in London. Since it did not engage in financing or banking operations, and its purpose was to provide the investor of moderate means the same advantages as those of more affluent investors (i.e., diminishing the risks and at the same time taking advantage of investing by spreading investments over a number of different securities), this can be called one of the first investment companies. Massachusetts Investors Trust, the first mutual fund as we know them today, was organized in 1924. SBICs came into existence following enactment of the Small Business Investment Act of 1958 (the 1958 Act).

The investment company industry has changed dramatically since its origin. Initially, the business was characterized by one-

[2] Investment Company Amendments Act of 1970.

[3] See *Audits of Stock Life Insurance Companies* (New York: AICPA, 1972).

or two-man managements, relatively simple investment techniques, and rudimentary sales practices. Today these characteristics are outmoded, investment techniques have become more sophisticated, and selling practices more creative and aggressive. The industry has attracted insurance companies, conglomerates, banks, and others. For all its attractiveness as an area of practice, the auditor should be aware that the investment company industry is, in reality, highly specialized, intensely competitive, and subject to specific governmental regulation, special tax treatment, and public scrutiny. Accordingly, it is essential that the auditor, before undertaking an investment company audit, become thoroughly familiar with the industry, its language, operating techniques, regulation, and thrust of current and past litigation and legislation.

Definition and Classification

"Mutual fund" is the popular name for what the 1940 Act defines as an "open-end management investment company." "Open-end" means that it stands ready at any time to redeem its outstanding shares at current net asset value. Normally, there is no trading market for shares of an open-end company. While it is not required to offer its shares for sale to the public on a continuous basis, most open-end companies do. The "offering price" of the shares of most mutual funds represents net assets (excess of assets, with investments stated at value, over liabilities) divided by the number of shares outstanding; the resulting per-share net asset value may be increased by a sales charge or "load" that provides commissions to the underwriter and dealer. Funds which sell shares at net asset value without any sales charge are referred to as "no-load" funds. Some funds may charge a premium on redemptions, but generally shares are redeemed at net asset value.

A "closed-end management investment company" does not stand ready to redeem its outstanding capital shares but may offer its shares to the public at its discretion; however, this is usually limited on a continuing basis to reinvestment of capital gains distributions. Its outstanding shares are traded on the open market at prices established by supply and demand, although the market prices are influenced by the company's net asset value (with investments valued on the same basis as that of mutual funds), which usually is reported on a regular basis in financial publications.

Investment companies can be classified[4] as diversified or non-diversified and further, depending upon their primary investment objective, into groups such as income, growth, balanced, or various combinations thereof. Income funds usually invest in high-yield common and preferred stocks and debt securities, since their prime aim is to maximize income. Growth funds invest mostly or entirely in stocks with anticipated above-average appreciation potential. Balanced funds emphasize growth and income, together with safety, by spreading their investments widely among common and preferred stocks and debt securities.

Closed-end investment companies, as mentioned above, include venture capital investment companies and SBICs. A venture capital investment company is a closed-end company whose primary investment objective is capital growth and whose capital is invested at above-average risk to form or develop companies with new ideas, products, or processes. SBICs are corporations which provide equity capital and/or long-term loans to small businesses, are licensed by the Small Business Administration under the 1958 Act, and may also be registered under the 1940 Act or be subsidiaries of a 1940 Act company. An SBIC may be a venture capital company or a finance company, depending on its business purpose and objectives. It may obtain financing from the federal government in the form of subordinated debentures, based on the amount of its equity capital and the amount of its funds invested in venture-type investments.

A unit investment trust is an investment company organized under a trust indenture or similar instrument, which has no board of directors and issues only redeemable securities, each of which represents an individual interest in a unit of specified securities. Earlier unit investment trusts invested in a specified list of securities, but those formed more recently (in the last 15 or 20 years) generally invest in municipal bonds or securities of a single issuer, usually shares of a particular mutual fund. The latter are formalized methods of accumulating mutual fund shares under a periodic payment plan or a single payment plan.

[4] Section 5(b) of the 1940 Act.

Such unit investment trusts are commonly known as contractual plans. For a further discussion of unit investment trusts, see Appendix D.

Organizations Providing Services to Investment Companies

Most mutual funds and many closed-end companies, being merely pools of funds, have no employees and are provided services by other entities, such as an investment adviser (manager), a principal underwriter (distributor), a custodian, and a transfer agent. The manager and distributor are usually affiliated, with the distributor function being performed by a separate division or subsidiary company of the manager corporation.

The manager generally provides investment advice, research, and certain administrative services in return for an annual fee under a contract usually based upon a percentage of specified average net assets. Some companies have fee schedules providing for a reduced percentage rate when the net assets of the company exceed certain limits. Other companies utilize performance fee schedules which provide for a basic fee percentage plus a bonus (or less a penalty) if the company's performance exceeds (or fails to equal) changes in a market index specified in the investment advisory agreement. When a performance fee schedule is utilized, the potential bonus for performance better than the index must be matched by an equivalent potential penalty for poor performance.[5] The investment advisory contract must be approved by a majority of the directors who are not "interested persons" as defined by the 1940 Act and by a majority of the fund's stockholders prior to its becoming effective. The contract cannot continue in effect for more than two years, unless each annual continuance has been specifically approved prior to the expiration date by a majority of the directors who are not "interested persons."[6]

The distributor performs the selling function for the fund as either an agent or a principal (see Chapter 4). It sells shares

[5] Release No. 7484 under the 1940 Act.
[6] Sections 2(a)(19), 15(a) and 15(c) of the 1940 Act.

either as a wholesaler through independent dealers or as a retailer through its own sales network. Sales are made at net asset value, usually plus a sales charge (load) from which the underwriter and dealers' commissions are paid. The size of the sales charge is subject to regulation by the National Association of Securities Dealers (NASD). A no-load fund may or may not have a distributor. Requirements for approval of a distributor's contract are similar to those for the investment adviser, as described above.

Except for the rare instance where an investment company retains custody of its own securities, custody of the company's cash and portfolio securities is entrusted to a bank (or less frequently to a member of a national securities exchange), which is held responsible for their receipt, delivery, and safekeeping. Custody arrangements and the auditor's responsibilities relating thereto are discussed in greater detail in Chapter 3.

Issuing, transferring, redeeming, and accounting for capital shares of a mutual fund are usually done by a fund-appointed agent, commonly called a transfer agent, which may be a banking institution or a private company, although in some instances the manager, distributor, or other related party performs these functions. Further discussion of these functions is found in Chapter 4.

Thus it can be seen that the major functions which may be performed by organizations other than the investment company are portfolio management, sales of shares and administration, record keeping and custodianship. No one function is any less significant than any other. The auditor is often called upon for accounting advice and other assistance in the administrative and record-keeping areas. It should be emphasized that the responsibility for the maintenance and reliability of accounting records and the accuracy of financial reports rests with the officers and directors of the company. Often a company will appoint a committee of "unaffiliated" directors to meet with the independent auditor from time to time. Such an audit committee can be of use to the directors in fulfilling their responsibilities.[7] However, the use of agents for the performance of accounting or other administrative functions does not relieve the officers and directors

[7] Accounting Series Release No. 123 (see Glossary).

of an investment company from the responsibility for fairness of financial reporting.

Legislation

During the 1960s and 1970s, the Securities and Exchange Commission initiated several investigations into the securities industry, and the investment company industry did not escape this scrutiny. In 1962, the Commission sponsored "A Study of Mutual Funds" (commonly known as the "Wharton School Report") covering major aspects of open-end companies, including their growth, organization and control, investment policy, performance, impact on securities markets, and relationships of such investment companies with investment advisers and principal underwriters.

Another notable example of a report resulting from Commission investigations is the report of the Commission made in 1966 to Congress on the "Public Policy Implications of Investment Company Growth." This report focused its attention primarily on the areas where the growth of mutual funds provoked questions as to the adequacy of the then-current regulatory controls. The report discussed the management function and its cost, allocation of mutual fund portfolio brokerage, and affiliations between investment companies and brokers who carried out securities transactions for the companies, evaluated mutual fund sales charges and their fairness, examined the relationship between mutual funds, considered size and performance, considered the impact of mutual fund growth and the increasing importance of other institutional investors on the securities markets, and discussed questions relating to investment company relations with portfolio companies and similar matters.

Other significant reports issued by the Commission include its disclosure policy study of 1969 (the Wheat Report), the "Institutional Investor Study Report" submitted to Congress in 1971, and the "Policy Statement on Future Structure of the Securities Markets" issued in 1972. The Institutional Investor Study Report was an economic study of institutional investors and their effects on the securities markets, issuers of securities and the investing public. The Policy Statement proposed creation of a "central market system," a system of communication tying together the various elements of the marketplace with a set of rules outlining the relationships of all participants.

Regulation

In general, any investment company whose outstanding securities, other than short-term paper, are beneficially owned by more than 100 persons (including the number of beneficial security holders of any company owning 10 percent or more of the voting securities of the investment company) or which is making, or proposes to make, a public offering of its securities, is required to register with the Securities and Exchange Commission under the 1940 Act.[8] Prior to offering its capital shares for sale to the public, the investment company must also register those securities under the Securities Act of 1933 and register with various state securities commissions. After registration with the Commission under both Acts, the company is required to report periodically to its shareholders and to the Commission. Accordingly, it is essential for auditors of investment companies to familiarize themselves with the following:

1. *Securities Act of 1933,* which is often referred to as the "disclosure act," governs prospectuses and similar documents and is intended to assure that potential investors receive adequate information to make reasonably informed investment decisions.
2. *Securities Exchange Act of 1934,* which regulates securities brokers and dealers, stock exchanges, and the trading of securities in the securities markets. The principal underwriter of the fund's shares, often called the "distributor," must register under this Act as a broker/dealer. It, together with the 1940 Act, also governs disclosures in proxy material used to solicit the votes of shareholders of investment companies.
3. *Investment Company Act of 1940,* which is designed specifically for the investment company industry and provides rules or regulations governing fiduciary duties and other responsibilities of investment company management.

[8] Section 3 of the 1940 Act.

4. *Investment Advisers Act of 1940,* which requires registration of persons who, for compensation, render investment advice to individuals or institutions, including investment companies, and regulates their conduct and contracts.
5. *Small Business Investment Act of 1958,* which authorizes the Small Business Administration to provide government funds under regulated conditions to small business investment companies licensed under the Act.
6. *"Blue Sky Laws,"* which are state statutes regulating the offering or sale of corporate or other securities, and the activities of securities brokers and dealers and investment advisers within the respective states.
7. *Securities and Exchange Commission "Statement of Policy,"* which establishes standards of uniformity and clarity as to charts, statistics, advertising, and sales literature used by investment companies and their distributors.

The federal securities laws are supplemented by formal rules and regulations, and the Commission also issues a variety of other releases and statements, including its Accounting Series Releases and releases under the 1933, 1934, and both 1940 Acts. Many of these are pertinent to the investment company industry and of particular interest to the auditor. The auditor should obtain and study carefully the Commission registration and reporting forms. The forms give a flavor of the type of information that has to be made available to the public, the restrictions imposed upon operations, the most applicable statutory provisions, and the statistics that need to be accumulated and maintained. These forms include the following:

1. *Form N-8A,* the notification of registration form under the 1940 Act, sets forth the name and address of the company and certain other general information. After the filing of this quite brief form, an investment company is registered under the 1940 Act and becomes subject to all of its requirements and standards. There are no audit requirements to this form.
2. *Form N-8B-1,* the registration statement for open-end and closed-end companies under the 1940 Act, describes in detail the company's objectives, policies, management, investment restrictions and similar matters and requires audited financial

statements which often present only initial financing arrangements.

3. *Form S-5*, the registration statement which registers the securities to be offered under the Securities Act of 1933 for open-end funds, consists principally of the "prospectus" and describes the fund's objectives, policies, management, investment restrictions, and other data as set forth in Form N-8B-1, including audited financial statements. (*Form S-4* is the comparable registration statement for a closed-end company.)
4. *Form N-1Q*, the calendar quarterly report of management investment companies to the Commission under the 1940 Act is intended to update Form N-8B-1 for significant events occurring within the preceding quarter and to provide information on quarterly purchases, sales, and holdings of individual portfolio securities. There are no audit requirements to this form.
5. *Form N-1R*, the annual report of management investment companies to the Commission under the 1940 Act, is intended to update the information contained in Form N-8B-1, to provide additional current material, and to demonstrate compliance with the 1940 Act. Form N-1R contains audited financial statements and has a number of responses which must be subjected to a compliance examination by the independent accountant; specific reporting thereon is required and, in addition, the auditor must comment on his review of the accounting system and the system of internal accounting control. Some of these aspects which affect the auditor are discussed in "Compliance Examination," page 12.
6. *Form N-5*, the registration statement for closed-end companies which are also licensed under the Small Business Investment Act of 1958 as small business investment companies is a dual purpose form, registering an SBIC under both the 1933 Act and the 1940 Act. It contains the same type of information and audited financial statements as are required by Forms N-8B-1, S-4 and S-5 for management investment companies.
7. *Form N-5R*, the annual report to the Commission under the 1940 Act for small business investment companies. The certified financial statements required by this form include a

copy of the annual financial report filed with the Small Business Administration under the 1958 Act (Form 468).

There are other forms pertinent only to unit investment trusts (Forms N-8B-2, S-6, N-30A-2) and face-amount certificate companies (Form N-8B-4) as well as other forms for special situations. The content of these forms and instructions relative to them should be studied by auditors of these specialized types of investment companies. This guide does not deal further with reporting problems peculiar to these specialized companies.

Information included in a currently effective prospectus must be updated for significant events occurring since the effective date. Prospectuses of mutual funds currently offering their shares for sale generally are updated at least annually. Amendments, including updated audited financial statements, must be filed and be declared effective within 16 months after the end of the period covered by the old audited financial statements if the fund is to continue making an offering of its shares.

Registration statements and reports filed for open-end and closed-end companies (other than SBICs) on the various forms require condensed financial information of the companies which is substantially different from that in other industries. This information, entitled "Per-Share Income and Capital Changes," requires information including net asset value, income, expenses, dividends, realized and unrealized gains and capital gain distributions, presented on a per-share basis, in most cases for the preceding ten years in registration statements and for the current year in annual reports filed with the Commission. Instructions to Forms N-8B-1 and N-1R describe specifically how these per-share figures should be calculated.

The financial statements required in registration statements consist principally of a balance sheet including a portfolio of investments (in an initial filing as of a date within 90 days of the date of filing the registration statement) and statements of income, realized gain or loss on investments and unrealized appreciation or depreciation of investments, surplus, and changes in net assets for the three full years immediately preceding the date of registration. The form and content of financial statements filed with the Commission is governed by Regulation S-X, Article 6 of which deals specifically with investment companies (Article 5 for SBICs).

Stockholder Reporting

The 1940 Act and the related rules and regulations thereunder[9] specify the financial statements and timing of reports required to be submitted to stockholders and to the Commission. Reports containing financial statements (frequently audited) must be submitted, at least semiannually, to stockholders and to the Commission; annual reports must contain audited financial statements. These reports must include the following:

1. A balance sheet.
2. A portfolio of investments in securities.
3. A statement of income and expense.
4. A statement of surplus.

An investment company may (and most do) include, in lieu of the balance sheet and the statement of surplus, (a) a statement of assets, liabilities, and net assets and (b) a statement of changes in net assets.

Compliance Examination

Form N-1R contains a number of responses required to be reported upon by the independent accountant. Certain of these items, including condensed financial information, issuance and redemption of securities, monthly sales of shares, etc., are of a statistical nature and are easily susceptible to audit techniques. Information as to certain other items such as underwriting commitments, services provided by the investment adviser, and the time lapse between sale of shares and receipt of proceeds are not necessarily of a statistical or financial nature and require extensions of audit procedures beyond the scope of a normal examination of financial statements.

The accountant's examination must, to the extent considered necessary in determining the scope of his examination, include a review of the accounting system and the system of internal accounting control, including that of outside agents (custodian, transfer, shareholder accounting—see Chapters 3 and 4). Based on that review, the accountant is required to set forth in his

[9] Section 30 of the 1940 Act and rules thereunder.

report included in Form N-1R comments upon any conditions which he believes are material weaknesses in the system and shall indicate any corrective action taken or proposed. See Chapter 6 for further discussion on Form N-1R requirements.

Accounting Rules

Rules under the 1940 Act prescribe the accounting records that an investment company must maintain and the periods for which they must be maintained.[10] These rules require maintenance of journals, general and auxiliary ledgers, and memorandum records, which are subjected from time to time to periodic and special examinations by representatives of the Commission.

The 1934 Act specifies the records that must be maintained by the principal underwriter for the fund, the period for which the records must be preserved, and the reports which must be filed by the principal underwriter with the Commission.[11] The records are subject to examination by representatives of the Commission. Each principal underwriter is required (as are other broker/dealers) to file, once during each calendar year, a report on financial condition which must be accompanied by a report of an independent accountant. The Commission has specified certain minimum audit requirements which must be followed by the independent accountant in conducting his examination. His report also must include comments upon any conditions believed to be material weaknesses found to exist in the accounting system, the internal accounting controls and procedures for safeguarding securities, and the practices and procedures employed quarterly in counting or accounting for securities and resolving securities differences, and must indicate any corrective action taken or proposed. The independent accountant should refer to the AICPA publication, *Audits of Brokers and Dealers in Securities,* for further discussion of this topic.

Other Rules

The 1940 Act defines current net asset value for use in computing periodically (usually daily) the redemption price and

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[10] Rule 31a-1 of the 1940 Act.

[11] Rules 17a-4 and 17a-5 of the 1934 Act.

the public offering price of the fund's shares.[12] This rule illustrates the need for care in accounting, since the offering and redemption prices are determined by the balances of the asset, liability, and capital accounts. See Chapter 6 for a more detailed discussion of net asset value computation.

The 1940 Act specifies the type of notice to stockholders that must accompany distributions from sources other than accumulated undistributed net investment income, describing the source of such distributions.[13] This notice must clearly indicate what portion of the payment (per share of outstanding capital stock) is made from (1) net income or accumulated undistributed net income, (2) realized gains or accumulated undistributed net gains on the sale of securities, and (3) paid-in surplus or other capital sources.

The 1940 Act requires that the independent accountant reporting on financial statements of management investment companies must be selected by a majority of those members of the board of directors who are not "interested persons" at a meeting held within 30 days before or after the beginning of the fiscal year or before the annual meeting of stockholders in that year. The directors' selection must be submitted for ratification at the next succeeding annual meeting of stockholders. Any vacancy occurring between annual meetings due to the death or resignation of the independent accountant may be filled by the appointee of the disinterested directors.[14]

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[12] Rule 2a-4 of the 1940 Act.

[13] Section 19 and Rule 19-1 of the 1940 Act.

[14] Section 32(a)(2) of the 1940 Act.

Chapter 2

Introduction to Accounting Policies and Reports of Investment Companies

The accounting policies followed by investment companies emanate from their role as a conduit for investors interested in investing funds as a group in the securities of business enterprises operated by others. As indicated earlier, accounting policies and the form and content of financial statements of investment companies are influenced to a great degree by the rules and regulations of the Securities and Exchange Commission and the Small Business Administration issued under the various Acts they administer.

Valuation of Securities

Values of securities held by investment companies are as important to the investor as the investment income earned and the gains and losses realized from security transactions. For this reason the general practice in the investment company industry is to disclose, in one form or another, valuation of securities at quoted market values or, in the absence of quoted values, at fair values determined by the directors in good faith. Under the 1940 Act, open-end management investment companies are required to report their securities at value while closed-end management investment companies may elect to report their securities at value (as most do) or at cost with value shown parenthetically. On the other hand, under the policies and regulations of the Small Business Administration, small business investment companies must report their securities at the lesser of cost or estimated realizable value and disclose value parenthetically. (While such accounting is required for reports to regulatory authorities at this time, it is to be hoped that this requirement will be revised by the Small Business Administration to bring the accounting principles for SBICs into agreement with other types of investment companies. For an example of an auditor's report on financial statements of an SBIC presented at the lesser of cost or value, see Chapter 8.)

In general, all investment companies should report their security investments at value. In certain cases the type of investment may complicate the determination of value. Specifically, as to venture-type investments (that is, investments in closely held, immature, and often illiquid companies, most of whom have net yet gone public but expect to do so in the future) which are usually made by venture capital closed-end companies (including SBICs, whether registered under the 1940 Act or not), there are a number of factors which should be considered. For instance, while the investor in other securities is usually passive, investors in venture situations in essence become financial partners in their "venture." Their involvement does not cease with the investment and subsequent market action, but rather contemplates a working relationship between the investor and the investee. Also, venture-type investments are made by providing funds directly to the venture, rather than by purchasing securities in the marketplace. Investments are often made in packages (combinations of debt, convertible issues, warrants, preferred and common shares) and involve rights not normally associated with traditional securities (rights of inspection, attendance at board meetings, first refusals on financings, etc.). In addition, because the initial investment position is often modified as time passes, considerable complexity is introduced into the process of recognizing gain or loss on disposition of specific securities and valuation of the portfolio. For these and other reasons, cost may be the most appropriate measure of value of venture-type securities, but only until there is evidence that value is other than cost. Such evidence may be developed by reference to various factors which are used in valuing securities in good faith, as discussed on page 35 in Chapter 3.

Effective Date of Transactions

In order to include in financial reports the effect of all securities trades entered into by or for the account of the investment company, the established practice in accounting for security purchases and sales is to record the transactions on the trade date[1] (date on which securities are purchased or sold), rather than the settlement date (date on which securities are to be delivered and paid for, the practice generally followed by securities brokers and dealers). Similarly, investment companies record dividend income on the ex-dividend date, rather than on the record or payable date, because that is the date on which the quoted market price of listed securities excludes the dividend declared. Also, distributions to shareholders by investment companies are not recorded by the investment company on the declaration date as they are by ordinary corporations, but on the ex-dividend or ex-distribution date, in order to show properly the shareholders' equity in net assets, especially on the per-share basis reported to the public.

Equalization Theory

An accounting practice unique to investment companies is the equalization theory followed by certain open-end management investment companies. The theory was adopted in the 1930s in an attempt to keep the continuing shareholder "whole" as to his rights in undistributed income by applying a portion of the proceeds from sales and costs of repurchases of capital shares (equivalent to the amount on a per-share basis of distributable net investment income on the date of the transaction —through equalization credits or debits) to undistributed income.

This theory states that the net asset value of each share of capital stock sold or repurchased is composed of par value of the stock, undistributed net investment income, and the remain-

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[1] Rule 2a-4 of the 1940 Act. See also "Net Asset Value Computation," page 74.

der, paid-in and other surplus. On dates on which shares are sold or repurchased, the investment company establishes the amount of undistributed net investment income available for distribution to its shareholders and, based on the number of shares outstanding, determines the amount associated with each share. On sales of shares, the per-share amount so determined is credited to the equalization account and on repurchases of shares, such amount is charged to the equalization account. To illustrate the manner in which equalization is applied, assume that an investment company has 1,000,000 shares outstanding and net assets of $7,500,000 composed of $1,000,000 representing par value of outstanding capital stock, $4,000,000 of paid-in surplus, $1,000,000 of undistributed net realized gains from security transactions, $1,000,000 of unrealized appreciation of investments, and $500,000 of undistributed net investment income. The investment company will receive $7.50 for each share sold and will account for such proceeds by crediting $1.00 to capital stock, $6.00 to paid-in surplus, and $.50 to the equalization account ($500,000 of undistributed net investment income divided by 1,000,000 shares). For any shares repurchased on that same date, the same amounts would be charged to the equalization account, capital stock, and paid-in surplus, respectively. Accordingly, regardless of the volume of shares sold or repurchased, the equalization theory permits each share of capital stock to retain the same per-share amount of undistributed net investment income it earned or acquired.

On the other hand, where equalization is not applied, the per-share equity of each shareholder in undistributed income fluctuates as the number of shares outstanding increases or decreases. Using the same example cited in the preceding paragraph, the per-share equity in undistributed net investment income would fall from $.50 to $.40 if 250,000 additional shares of capital stock were sold and conversely would rise to $.55 if 100,000 shares were repurchased. However, it should be recognized that equalization accounting will not have a significant effect on the amount of undistributed net investment income unless the investment company experiences significant changes in outstanding shares.

Equalization of undistributed income but not of losses nor of undistributed realized gains or losses from security transactions is considered an acceptable practice. In principle, net equalization credits should be distributed to shareholders.

Taxes

Investment companies that qualify under Subchapter M of the Internal Revenue Code and distribute all their investment company taxable income and taxable realized gains from security transactions are relieved of federal income taxes. Accordingly, such qualified companies need not provide for current or deferred federal income taxes on investment income, realized gains on security transactions, or unrealized appreciation of investments. In those instances where such qualified companies do not distribute all realized long-term gain on security transactions but elect to pay the federal income tax on such gains for the account of their shareholders, the liability and the related "deemed" distribution are recorded at the end of the last day of the investment company's taxable year (and not earlier) since only shareholders of record at that date are entitled to the credit for taxes paid by the investment company on their behalf.[2]

State, local, and foreign taxes, where appropriate, are provided on the accrual basis, including, if material in relation to net assets, deferred state, local and foreign taxes on the unrealized appreciation of investments.[3]

If a company is not qualified under Subchapter M of the Internal Revenue Code, in addition to federal income taxes on net investment income and realized gains or losses on investments, provision for deferred federal income taxes on unrealized appreciation (or depreciation where appropriate) of investments ordinarily would be required.

Financial Statements

Because of the emphasis on reporting net asset value, the financial statements of investment companies are quite different from those of companies in other industries. Financial statements that traditionally have been issued by investment companies include,

[2] Accounting Series Release No. 114 of the Securities and Exchange Commission and Section 852 of the Internal Revenue Code.

[3] APB Opinion No. 11, "Accounting for Income Taxes."

in varying combinations, a statement of assets and liabilities, balance sheet, statement of investment income and expense, statement of realized gain or loss on investments, statement of unrealized appreciation or depreciation of investments, statement of income, surplus statement, statement of changes in net assets, and statement of sources of net assets. In the interest of comparable reporting format by companies of a similar type, the presentation of the following three financial statements should give sufficient financial information to shareholders and other interested parties provided the statements disclose the information covered here and more fully discussed and illustrated in Chapter 7 of this guide.

Statement of Assets and Liabilities. In lieu of the conventional balance sheet, most investment companies present a statement which lists the assets, including an accompanying detailed listing of investments in securities at value, deducts liabilities, and arrives at "net assets" (comprising accumulated net proceeds of capital shares sold, less cost of shares repurchased, undistributed investment income, undistributed realized gains and losses from security transactions, and unrealized appreciation or depreciation of investments). This statement should also show the number of capital shares and the net asset value for each capital share outstanding at the close of the period.

The portfolio of investments in securities should list the securities at the close of the period by major classifications, such as (1) by investments in common stocks, preferred stocks, convertible issues, United States Government and Agency obligations (except short-term money market instruments), other investment companies, short-term portfolio investments, and other securities; (2) by equity securities and debt securities; (3) by securities held within industry groups; or (4) by a combination of these classifications. Venture capital companies and SBICs may prefer to list all securities of an individual issuer together.

The portfolio should list each security issue with the number of shares or principal amount of the securities and value,[4] with cost shown parenthetically for each separate category, such as common stocks, preferred stocks, etc. or for industry groups, as

[4] Rule 12-19 of Regulation S-X and Rule 30d-1(c)(2) of the 1940 Act.

may be appropriate under the circumstances. Short-term portfolio investments should be summarized by issuer and by ranges of maturity dates. Short-term securities held as temporary utilization of cash (for planned distribution to shareholders, payment of liabilities, etc.) may be separately classified in the statement as other than portfolio securities.

The basis for determining the value of the securities should be disclosed in a note to the financial statements or in a separate statement of significant accounting policies. Investments in restricted securities and in affiliated companies require special disclosure in the portfolio of investments and specific information in notes to the financial statements concerning method of valuation.

As indicated on page 106, a Statement of Net Assets, is an acceptable alternative method of presenting the statement of assets and liabilities and portfolio of investments.

Statement of Operations. This statement should present the results of all of the investment activities of the company by reporting separately net investment income or loss and the combination of realized gain (loss) from security transactions and change in unrealized appreciation or depreciation of investments.

Statement of Changes in Net Assets. This statement should present information generally shown in statements of shareholders' equity and changes in financial position in conventional financial statements, by summarizing, separately, the changes resulting from investment activities and those from capital share transactions.

In addition to the above financial statements, registered investment companies are required to file reports with governmental agencies furnishing information concerning compliance with provisions and related rules and regulations of the 1940 Act and the Small Business Investment Act. Chapters 1 and 6 deal more specifically with certain aspects of such compliance reporting.

The continuing challenges of producing meaningful information to the investor include the need for ongoing study and research into methods of reporting on such operations of the investment company as investment performance, operating efficiency and portfolio activity. Some of these aspects of the investment company's operations are included in the reporting covered in this guide. However, experimentation in other directions should be encouraged. For instance, information as to performance of individual securities during the period might be helpful, such as disclosure of those securities whose aggregate realized gain or loss and change in unrealized appreciation or depreciation have exceeded a stated percentage of net assets, or identification of those securities which have been the major contributors to both increases and decreases in net assets. Investment companies are encouraged to develop such reporting techniques.

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The operations of investment companies center on four principal areas:

1. Security transactions and related investment income.
2. Capital share transactions and distributions to shareholders.
3. Tax considerations.
4. Other aspects and accounts peculiar to investment companies.

In the next four chapters the operations, controls, and accounting principles and the auditing procedures considered appropriate for each of these areas will be covered in a manner that will focus on the independent auditor's responsibility for disclosure in and reporting on the financial statements and other reports of investment companies.

Chapter 3

Investment Accounts

Portfolio securities represent the most significant asset group in the statement of assets and liabilities of an investment company, typically accounting for all but a small part of the company's assets. Dividends, interest, realized gains or losses on the disposition of investments, and changes in unrealized appreciation or depreciation of investments result from such holdings.

OPERATIONS, CONTROLS, AND ACCOUNTING PRINCIPLES

Investment Objectives and Policies

The composition of the investment portfolio varies from one investment company to another as it is primarily a function of the basic investment objectives and the particular market strategy used to achieve such objectives. As indicated in Chapter 1, such objectives may emphasize capital appreciation (growth), a balance between appreciation and income, or the maximizing of current income. In addition, the portfolio may be widely diversified or specialized as to industry, in each case reflecting various degrees of risk.

The basic investment objectives adopted by management as well as the related techniques to achieve them are disclosed in appropriate documents such as the charter or partnership agreement, the registration statement, prospectus, or offering circular. This is accomplished by specifying investment limitations which, typically, may include the permissible degree of concentration of investments in particular industries, limitations, or outright prohibitions with regard to the purchase and sale of real estate, commodities or commodity contracts, other non-security investments, investments in unregistered securities, short sales of securities, the underwriting of securities of other issuers, the acquisition of securities of other investment companies, or the use of leveraging techniques such as margin accounts, bank borrowing and writing or investing in options.

The company may also specify the types of securities (such as bonds, preferred stocks, convertible issues, common stocks, warrants, or options) in which it may invest and the proportion of total assets that may be represented by each type of security. Similarly, limitations generally are specified as to the percentage of its assets the company may invest in the securities of any one issuer, the percentage of voting securities of any one issuer it may acquire and investments in companies for the purpose of exercising control over management. On occasion, management may choose to limit portfolio turnover. To the extent that the company chooses to make any of the foregoing limitations a matter of fundamental policy, shareholders' approval usually would be required to bring about any changes in such provisions. Section 13 of the 1940 Act requires such approval.

Federal Income Tax Provisions Affecting Investment Accounts

Investment companies which elect to qualify as regulated investment companies under Subchapter M of the Internal Revenue Code must meet the various requirements set forth more fully in Chapter 5. In considering investment policies, it should be borne in mind that Subchapter M provides that:

(1) a regulated investment company must meet certain diversification requirements as to its total assets as of the close of each quarter of its taxable year,

(2) it must derive at least 90 percent of its gross income from dividends, interest, and gains from the sale or other disposition of securities, excluding capital losses, and

(3) less than 30 percent of its gross income must be derived from the sale or other disposition of securities held for less than three months.

See Chapter 5, "Taxes," for information concerning special consideration given to venture capital companies under the Internal Revenue Code.

Record-Keeping Requirements Related to Investment Activity

As mentioned briefly in Chapter 1, under the 1940 Act[1] there are minimum accounting records that registered investment companies are required to maintain. These basic investment records (which are desirable for all investment companies) are as follows:

1. Journals or other records of original entry containing an itemized daily record of all purchases and sales of securities, their receipt and/or delivery, and the collection and/or disbursement of cash relating to such transactions.
2. A securities record or ledger showing separately for each portfolio item, as of the trade date, the quantity, unit, and aggregate price for each purchase and sale. (As discussed later in this chapter, such record should provide for identification of average cost and the cost used for financial reporting and income tax purposes.)
3. A record for each portfolio item of all trading orders placed for the purchase or sale of such securities by or on behalf of the investment company and the action taken with respect to each order.

As a general rule, for 1940 Act companies, these books and records must be retained permanently or for a minimum of six

[1] Section 31 of the 1940 Act and rules thereunder.

years and must be made available to representatives of the Securities and Exchange Commission in connection with periodic or special inspections.[2]

To the extent that these records and other records required to be maintained by Rules 31a-1 and 31a-2 of the Act are maintained by agents (such as the custodian or transfer agent) on behalf of the company, the company should obtain an agreement in writing from the agent stating that he will make such records available upon request and will preserve them for the required period of time.

Custody of Securities

Custody of an investment company's securities usually is entrusted to a bank which, in the case of a registered company, must have certain minimum aggregate capital, surplus, and undivided profits.[3] In other cases, such custody function is performed by a member firm of a national securities exchange, or by a central securities system registered with the Securities and Exchange Commission. It is good practice (required, for registered companies,[4] in the case where a member firm is custodian) to have a properly approved custodial agreement. For registered companies to use a member of a national securities exchange as custodian requires the approval of a majority of the investment company's board of directors initially and at least annually thereafter. Some of the more important provisions of the custodial agreement, a copy of which must be filed with the Commission by registered companies, concern physical and book segregation of securities in custody, denial to the custodian of the power to assign, hypothecate, pledge, or otherwise encumber or dispose of any securities except when acting at the direction and for the account of the investment company, and immunity of such securities to liens asserted by the custodian as well as

[2] Rules 31a-2, 31a-3, and 31b of the 1940 Act.
[3] Sections 17(f) and 26(a) of the 1940 Act.
[4] Section 17(f) of the 1940 Act and Guidelines to Form N-8B-1. (Release 7221 under the 1940 Act).

the right of the Securities and Exchange Commission and independent auditor to inspect such securities at any time.[5]

If the custodian is a member of a national securities exchange rather than a bank, the 1940 Act and the related rules[6] provide for the inspection of all securities through actual examination at various times by the investment company's independent auditor.

As another alternative, the investment company itself may assume responsibility for the custody function, provided the securities are deposited for safekeeping in a vault or other depository maintained by a bank or other company whose functions and physical facilities are supervised by federal or state authorities. Securities thus deposited are physically segregated and subject to withdrawal only by duly authorized individuals under specified conditions. The 1940 Act and the related rules provide for the inspection of all securities through actual examination at various times by the investment company's independent auditor.[7] See "Review of Internal Accounting Controls and Procedures," page 41.

If a registered company uses a bank as custodian for its securities, the proceeds from sale of such securities and other cash assets, except for amounts in a checking account or petty cash, must be kept in the custody of such bank.[8]

Company Procedures Relating to Day-to-Day Investment Activities

The overall investment activities of the company are the ultimate responsibility of the board of directors which typically delegates the day-to-day operating and investment decisions to an investment committee or a portfolio manager or investment adviser. In practice, investment decisions are communicated to designated employees of the investment company or its adviser who place orders with brokers. Prospectuses often indicate that the investment company has the responsibility to its shareholders

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[5] Section 17(f) of the 1940 Act.

[6] Rules 17f-1 and 17f-2 of the 1940 Act.

[7] Ibid.

[8] Releases 6863 and 7164 under the 1940 Act.

to seek out the broker who offers the best price and execution for any particular trade.

All communications with brokers leading to the placement of an order should be documented by an internal record showing the name of the person who placed the order, the name of the security, the number of shares or principal amount ordered, the price as well as the date and time when such order was entered, and the name of and the reason for using the selected broker. Brokers routinely confirm the execution of each order by telephone followed by a broker's written advice containing all information pertinent to the trade.

The investment company should notify the custodian promptly of each security transaction and should issue detailed receive/deliver and collect/disburse instructions in writing, including the name of the broker, the description and quantity of the security, the trade and settlement dates, and the net amount of cash to be collected or disbursed. As required by the Internal Revenue Code, the instructions should identify the securities to be delivered, by certificate number, date of purchase, or other acceptable method. These instructions should be signed by one or more authorized representatives of the investment company whose signatures are on file with the custodian; if instructions are made by telephone or telegraph, written confirmation of the instructions should follow promptly.

As advices confirming the trades are received from brokers, they should be reviewed promptly for conformity of terms, clerical accuracy, proper application of commission rates (including volume discounts or negotiated rates, as applicable), and should be compared to the internal record established at the time the order was placed. As discussed previously, the generally accepted practice for investment companies is to record securities transactions as of the trade date rather than as of the settlement date.

In almost all instances investment companies maintain so-called C.O.D. (cash on delivery) accounts with brokers under the terms of which the broker delivers securities to the custodian or receives securities from the custodian against collection or payment of the net settlement amount previously authorized by the investment company. Unless instructed otherwise, the custodian normally rejects the transaction if the number of shares and the settlement amount are not in complete agreement.

The custodian notifies the investment company promptly of all money settlements and receipts or deliveries of securities. The related advices should again be compared to the initial record of the order by the investment company to insure agreement. "Fails to receive or deliver" by the broker become apparent at this point and as a normal procedure should be followed up promptly with the broker.

The custodian will issue periodic statements listing all receipts and deliveries of securities and related collections and disbursements of cash since the last statement date. Securities on hand and the cash balance due from or due to the custodian at the end of the period may be listed in the so-called "bring down" or position portion of the statement following the chronologically arranged transaction listing. Investment company personnel should reconcile such custodian statements promptly with their own books and records and should initiate follow-up procedures on reconciling items on a timely basis. The investment company should be aware of the procedures and controls applied by the custodian as they relate to functions carried out on behalf of the investment company, especially those procedures surrounding safekeeping of securities. In theory at least, an investment company, as part of its internal control procedures, could physically count securities on deposit with the custodian as of selected dates. As a practical matter, however, the company in almost all cases, provided it is satisfied with the internal controls of the custodian, relies on the periodic position confirmations issued by the custodian. Although physically segregated, in many instances securities are held, along with securities belonging to others, in a common nominee name by the custodian, making positive identification difficult.

If the investment company acts as its own custodian, periodic physical counts by personnel not connected with the day-to-day custody function should be scheduled on a surprise basis. As an added protective measure, investment company personnel authorizing or handling cash and securities transactions should be (and in the case of a registered fund, must be) covered by fidelity insurance coverage regardless of whether the company acts as its own custodian or appoints a bank or member firm of a national securities exchange to perform this function.

Daily Net Asset Value

Open-end funds and certain closed-end companies typically compute the net asset value per share each day that the New York Stock Exchange conducts trading activity. Other closed-end companies and certain small, relatively inactive open-end funds may do so on a less frequent basis, such as weekly or semimonthly. Under the 1940 Act an open-end fund must compute net asset value daily for purposes of pricing any shares tendered for redemption and, for funds making a continuous offering of their shares, determining offering prices for sales of shares.[9] See Chapter 6 for an overall discussion of net asset value computation.

By far the most significant portion of the net assets consists of the securities portfolio stated at value. Changes in security positions are entered on the daily net asset value work sheet no later than in the first calculation prepared on the first business day following the trade date.[10] Due to the importance of this calculation (it determines offering and redemption prices) the investment company's internal control procedures often provide for independent checking of all securities prices and a review of the portfolio value computation by a responsible employee. As an added precaution, prices assigned to each security position may be compared to the prices used as of the preceding valuation date to detect increases or decreases in specific security prices of an unusual nature or in excess of a predetermined amount or percentage which would then be subjected to further scrutiny.

Accounting for Dividend and Interest Income

Dividends. As a general rule, cash dividends on investment securities are recorded as of the ex-dividend date on which the trading price of the security reflects an adjustment for the dividend declared. Occasionally, cash distributions represent a return of capital rather than current income to the recipient. In such instances, if pertinent information is known at the time, the distributions should be credited to the investment account rather

[9] Rule 22c-1(b) of the 1940 Act.
[10] Rule 2a-4 of the 1940 Act.

than to income. The accounting treatment for certain dividends and distributions can differ for financial reporting purposes from that required for income tax purposes. See "Other Considerations," page 67.

Stock splits and dividends in stock of the same class as that owned are not recorded as income since the investment company's equity interest in the company declaring the dividend or split has not changed. Certain dividend payments on preferred stocks which represent the liquidation of accumulated arrearages require special reporting as between dividend and other income.[11]

Dividends in kind are generally recorded as income at the fair value of the property received. In the case of dividends where the recipient has the option to receive cash or stock, income should be recorded for the amount of cash that could have been received. When stock rights are received, a portion of the cost basis of the related investment may be allocated to the rights on a pro rata cost basis; however, for book purposes many funds follow tax accounting[12] which does not require allocation in cases where the market value of the rights does not exceed 15 percent of the market value of the investment company's holdings.

Cash dividends declared on stocks for which the securities portfolio reflects a short position as of the record date should be recorded on the ex-dividend date and are shown in the financial statements of the investment company as a reduction of investment income.

As a matter of day-to-day operating routine, investment companies regularly consult published sources for daily dividend declarations to insure that all dividend income is properly received and recorded by the company or its custodian. Internal control procedures should include provisions for the systematic follow-up and disposition of dividends receivable which are not collected in the regular course of business due to delays in settling securities transactions or completing transfer procedures.

Interest Income. Interest income on straight debt securities, such as corporate, municipal, or treasury bonds is normally ac-

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[11] Rule 6.04 of Regulation S-X.

[12] Section 307 of the Internal Revenue Code.

crued on a daily basis. Discount on treasury bills is amortized to interest income in a similar fashion. Consideration should be given to making a provision for uncollectible interest accruals on securities where doubts exist as to the collectibility of the interest. Interest received on bonds which were in default when acquired should be treated

(a) as interest income of the current period up to the amount earned relative to the current period; then,
(b) as other investment income up to the amount earned from date of acquisition to the beginning of the current period; and
(c) as reduction of the cost of the investment as to the amount relative to arrearages at date of acquisition.[13]

Considering the frequent fluctuations in money market rates and the probable (based on past history and expressed intentions of funds holding such investments in their portfolios) turnover of bond portfolios prior to maturity, amortization of bond premium or discount does not provide, in most situations, meaningful adjustments to otherwise reportable investment income. However, in those instances where the company's securities portfolio contains significant positions of bonds acquired at a substantial discount or premium and where the company expects to hold such security positions of bonds over an extended period, consideration should be given to a systematic amortization of such discount or premium. It should be recognized that because investment companies carry their investments at market value, amortization or lack thereof has no effect on net asset value. (Refer to Chapter 5 concerning the amortization of original issue discount and premium in certain instances for tax reporting.)

The accrued interest receivable account should be analyzed at regular intervals to insure that interest payments becoming due are received promptly and in the correct amount. Similarly, the proper disposition of purchased interest receivable and interest accruals pertaining to debt securities sold between interest dates should be analyzed periodically.

[13] Rule 6.04 of Regulation S-X and Accounting Series Release No. 36.

Trade Date Versus Settlement Date Accounting

As indicated earlier, the generally accepted practice in the investment company industry is to record securities transactions as of the trade date rather than on a settlement date basis. As a consequence, the statement of assets and liabilities of most investment companies reflects receivables from brokers for securities sold (but not yet delivered against payment) and payables to brokers for securities purchased (but not yet received against payment) at the end of an accounting period.

Where a securities transaction was entered into by the investment company outside conventional stock market channels, such as through a private placement of investment letter stock, the date on which the investment company obtained an enforceable right to demand the securities or to collect the proceeds therefor, is the date as of which the transaction should be recorded. Such a determination, in certain instances, may be subject to interpretation by legal counsel.[14] Investments in real estate are handled in a similar manner.

Valuation of Securities

As stated in Chapter 2, all investment companies should report their securities portfolios at value. Value can be defined[15] as (a) with respect to securities for which market quotations are readily available, the quoted market value of such securities and (b) with respect to other securities and assets, fair value as determined in good faith by the board of directors.

Value of securities held is not reduced for normal brokerage commissions and other costs to be incurred in the ordinary course of business at the time of future sale.

The Commission in its Accounting Series Release No. 118 described various methods for valuing securities. These methods are summarized and discussed in the following paragraphs.

Securities Traded on a National Securities Exchange. Ordinarily, little difficulty should be experienced in valuing securities listed or traded on one or more security exchanges, since quota-

[14] Accounting Series Release Nos. 113 and 116.
[15] Section 2(a)(41) of the 1940 Act.

tions of completed transactions are published daily. If a security was traded on the valuation date, the last quoted sales price generally is used. In the case of securities listed on more than one national securities exchange, the last quoted sales price up to the time of valuation on the exchange on which the security is principally traded should be used or, if there were no sales on that exchange on the valuation date, the last quoted sale price up to the time of valuation on the other exchanges should be substituted. Registered companies value their portfolio at the time of the close of trading on the New York Stock Exchange.[16]

If there were no sales on the valuation date but published closing bid and asked prices are available, the valuation in such circumstances should be within the range of these quoted prices. Some companies, as a matter of general policy, use the bid price, others use the mean of the bid and asked prices, and still others use a valuation within the range considered best to represent value in the circumstances. Each of these policies is considered to be acceptable if consistently applied. Normally, it is not considered to be acceptable to use the asked price alone. Where, on the valuation date, only a bid price or an asked price is quoted or the spread between bid and asked price is substantial, quotations for several days should be reviewed. If sales have been infrequent or there is a thin market in the security, further consideration should be given to whether "market quotations are readily available" as a practical matter. If it is decided that they are not readily available, the alternative method of valuation, i.e., "fair value as determined in good faith by the board of directors" should be used.

Over-the-Counter Securities. Quotations are available from various sources for most unlisted securities traded regularly in the over-the-counter market. These sources include tabulations in the financial press, various quotation publications and financial reporting services, and individual broker/dealers. A company may adopt a policy of using a mean of the bid prices, or of the bid and asked prices, or of the prices of a representative selection of broker/dealers quoting on a particular security; or it may use a valuation within the range of bid and asked prices con-

[16] Rule 22c-1(b) of the 1940 Act.

sidered best to represent value in the circumstances. Any one of these policies is considered to be acceptable if consistently applied. Normally, the use of the asked prices alone is not acceptable.

Ordinarily, quotations for an over-the-counter security should be obtained from more than one broker/dealer unless available from an established market-maker for that security, and quotations for several days should be reviewed. In all cases, the quotations should be from unaffiliated persons. NASDAQ may be the most convenient source of such quotations. Where quotations appear questionable, consideration should be given to valuing the security at "fair value as determined in good faith by the board of directors."

United States Treasury bonds and notes usually bear longer term maturities than those classified under "Short-Term Investments" below and are often purchased, at least partially, for their capital appreciation potential. Such securities are valued at quoted market.

Securities Valued "in good faith." It is incumbent upon the board of directors to satisfy themselves that all appropriate factors relevant to the value of securities for which market quotations are not readily available have been considered and to determine the method of arriving at the fair value of each such security. To the extent considered necessary, the board may appoint persons to assist it in the determination of such value, and to make the actual calculations pursuant to the board's direction. Consistent with this responsibility, the board also must review continuously the appropriateness of the method used in valuing each issue of securities in the company's portfolio. The directors must recognize their responsibilities in this matter and whenever technical assistance is requested from individuals who are not directors, the findings of such individuals must be carefully reviewed by the directors in order to satisfy themselves that the resulting valuations are fair.

As Accounting Series Release No. 118 states, no single standard for determining fair value in good faith can be laid down, since fair value depends upon the circumstances of each individual case. As a general principle, the current "fair value" of an issue of securities being valued by the board of directors would appear to be the amount which the owner might reasonably expect to receive from them upon their current sale, although there usually is no intention to make a current sale. Current sale should be interpreted to mean realization in an orderly disposition over a reasonable period of time. Methods which are in accord with this principle may, for example, be based on a multiple of earnings, or a discount (or less frequently a premium) from market of a similar, freely traded security, or a yield to maturity with respect to debt issues, or a combination of these and other methods. Some of the general factors which the directors should consider in determining a valuation method for an individual issue of securities include (1) the fundamental analytical data relating to the investment; (2) the nature and duration of restrictions on disposition of the securities; and (3) an evaluation of the forces which influence the market in which these securities are purchased and sold. In the case of investments made in several securities of the same issuer, such as those made by many SBICs and venture capital companies, the valuation of the "package" as a whole may be appropriate. Among the more specific factors which must be considered are the type of security (debt or equity), financial standing of the issuer, availability of current financial statements, cost at date of purchase, size and period of holding, discount from market value of unrestricted securities of the same class at the time of purchase, special reports prepared by analysts, information as to any transactions or offers with respect to the security, existence of merger proposals or tender offers affecting the securities, reported prices and extent of public trading in similar securities of the issuer or comparable companies, maintenance of investee's business and financial plan, use of new funds to achieve planned results, changes in economic conditions including those in the company or industry, and other relevant matters.[17] This guide does not purport to delineate all factors which may be considered. The directors should take into consideration all indications of value available to them in determining the "fair value" assigned to a particular security. The information so considered and, insofar as practicable, the basis for the board's decision, should be documented

[17] Accounting Series Release Nos. 113 and 118.

in the minutes of the directors' meeting and the supporting data retained for the inspection of the company's independent auditor.

Valuation of Short Securities Positions. In the case of securities sold short, the difference between the net proceeds of the securities sold and the value of the securities required to be acquired to cover the short position should be included in unrealized appreciation or depreciation of investments. The value of the securities to be acquired should be determined generally in accordance with the appropriate method described above for securities traded on a national securities exchange, over-the-counter securities (except that a policy of using a mean of the bid and asked prices or of the asked prices is considered acceptable if consistently applied; normally, the use of the bid prices alone on short positions is not acceptable), and securities valued "in good faith." Realized gain or loss is recognized at the time the short position is closed out.

Valuation of Put and Call Options Purchased. It is a generally accepted practice among investment companies to amortize the cost of put and call options on a daily basis over the life of the option. If there is a decline in the market value of the shares under option below the call price at which the option can be exercised, or if the market value of the shares is in excess of the put price, the option should be valued in the portfolio at amortized cost less such decline, down to a value of zero. Conversely, if there is an increase in the market value of the shares under option over the call price or if the market value of the shares is below the put price, the option should be valued at such increase or at amortized cost, whichever is greater. The amortization of the option cost should be treated as a charge to realized gain (loss) from security transactions, and the difference between amortized cost and value should be treated as unrealized appreciation or depreciation for securities remaining in the portfolio rather than as a charge to investment income. If the option is exercised, the remaining unamortized portion of the cost of put options should be charged to realized gain (loss) from security transactions; for call options the unamortized portion should be included in the cost of the security received.

Valuation of Put and Call Option Contracts Written by the Investment Company. Premiums received from writing call options should be amortized to realized gain (loss) from security transactions on a straight line basis over the period of the option. If a call option is exercised, the remaining portion of the premium should be recognized as realized gain (loss) from security transactions. If the quoted market value of the security forming part of the portfolio of the option writer increases above the call price such increase should not be recorded; if the value decreases, such decrease should not be recorded unless it is greater than the unamortized premium income.

Premiums received from writing put options should be amortized to realized gain (loss) from security transactions on a straight line basis over the period of the option. If a put option is exercised, the remaining unamortized portion of the premium should be recognized as realized gain (loss) from security transactions. If the quoted market value of the security to be acquired by the option writer (and often sold short by him in anticipation of such purchase) increases above the put price, such increase should not be recorded; if the value decreases, such decrease should not be recorded unless it is greater than the unamortized premium income.

Management and the board of directors of an investment company must continually review the values arrived at by the aforementioned formulas. If another method of valuation of put and call options more fairly represents net realizable value in their opinion, such other value should be used.

Reference should be made to Chapter 5 for the discussion of the tax treatment of option contracts which vary significantly from the principles applied for financial reporting purposes.

Purchase of Entire Portfolio of Another Company. An investment company may acquire the entire portfolio of another investment company in a nontaxable exchange transaction. Such a transaction usually gives rise to an accounting cost basis for such securities which is different from the basis of the same securities for income tax purposes because, for financial reporting purposes, the investments acquired are assigned current market values whereas original tax basis continues to be used for income tax purposes.

In the case of a merger, to compensate in part for unequal income tax effect in the future, adjustments to the exchange ratio are appropriate to reflect the different proportions of undistributed realized gain or loss and unrealized appreciation or depreciation in the respective portfolios which exist at the date of exchange, as well as dispositions of securities expected to occur immediately after the exchange. The Commission will usually be of assistance to a registered company in establishing the adjustments to be made, and an example of an adjustment computation work sheet can be found in Appendix A to this guide. This computation is an example only and has no statutory basis. It, or a modification of it, has been used in most mergers in recent years and although admittedly arbitrary, serves as a basis for discussion as to any adjustment which may be appropriate. Further discussion of financial statement treatment of acquisitions and mergers can be found under "Business Combinations," page 83.

Short-Term Investments. Treasury bills and commercial paper may be purchased at face amount or at a discount from face amount. Since they represent short-term maturities and are purchased primarily for their interest yield, they are carried at original cost plus amortized discount or accrued interest which usually approximates market value.

Determination of Cost of Investment Securities

Cost of investment securities in the portfolio and net realized gain (loss) from security transactions for registered investment companies are determined for financial accounting purposes on the identified (specific certificate), first-in, first-out, last-in, first-out, or average cost method.[18] Each company should use a single method for all securities. Cost for these purposes includes brokerage and other items normally found on a broker's advice of purchase or sale. If the cost of securities sold is determined on other than the average cost basis the company should disclose (required for a registered company[19]) in a note, if practicable, what

[18] Rule 2a-2 of the 1940 Act.

gain or loss would have resulted if average cost had been used. When part of an issue of a particular security is sold, the cost of the securities sold for the purpose of computing gain or loss and the cost of the securities retained under the average cost method are computed by averaging the various costs of all the shares of that particular issue owned prior to the sale. Thus the average cost would only change as purchases are made; sales would not affect the average. The average cost method of computing gains and losses from sales of securities is not acceptable for federal income tax purposes. For tax purposes, therefore, all investment companies should maintain a record of security gains and losses computed by applying against the proceeds of a sale of securities the "identified cost" of the specific shares identified for delivery. In order to prevent wide fluctuation between net gains or losses from security transactions reported on the average cost basis and those reported on the identified or other cost basis, some investment companies attempt, to the extent possible, to identify for delivery against a particular sale specific shares having an aggregate cost near the average cost.

Cost of bonds in the portfolio and net gains from sales of portfolio bonds are determined for financial accounting purposes and for federal income tax purposes in the same manner as described above. However, when bonds are acquired, cost is broken down between the cost of the bond and the interest purchased, which is recorded as a receivable. Most funds follow the policy of not amortizing premiums or discounts on short-term holdings of bonds in the portfolio. See page 69 for a discussion of amortization policy.

Reference should be made to Chapter 5 for more detailed discussion of costs of investment securities for income tax purposes.

AUDITING PROCEDURES

The auditing procedures relating to the investment accounts of investment companies require greater attention than those of a commercial enterprise because of the relative significance of such assets. In both instances, of course, the independent auditor

[19] Rule 6.05 of Regulation S-X.

should evaluate the internal accounting controls as the basis for determining the extent of his examination. Audit objectives in the investment accounts area are to ascertain that

(1) the company has ownership of, and accounting control over, its portfolio investments;
(2) income from investments and realized gains and losses from security transactions are properly accounted for and that investment performance is presented realistically;
(3) portfolio investments are properly valued and cost thereof for book and tax purposes is properly recorded; and
(4) the investment company has complied with restrictions under its stated investment objectives and policies.

Review of Internal Accounting Controls and Procedures

The independent auditor should familiarize himself with documents such as the latest prospectus, the certificate of incorporation, bylaws, and minutes during the course of the examination. Further, if the company is classified as "diversified," the related provisions of the 1940 Act must be followed. There are other areas of compliance with which the auditor should familiarize himself. For instance, the 1940 Act contains record-keeping requirements, and many compliance items are to be reported on in the annual report to the Commission on Form N-1R discussed in Chapter 6. For those pertaining to taxes, see Chapter 5.

The location of the investment securities should be ascertained by the independent auditor prior to the commencement of his examination. He should evaluate the relationship between the company and the custodian of its securities as to (a) whether significant record-keeping problems exist, (b) the financial position of the custodian in relation to the company's assets that they hold, and (c) any other matters pertinent to the relationship. He should review, to the extent he considers necessary, the custodian's internal controls and make such inquiries as are appropriate. Such a review of controls might include, among other steps: consideration of the agent's procedures covering the receipt of securities and payment therefor, as well as delivery of securities and control over cash received; determination as to whether the company's securities are satisfactorily segregated, physically, in the custodian's vaults, and satisfactorily safeguarded; consideration of the adequacy of the controls over receipt of dividends (cash and other) and interest. Based on his evaluation of the controls, the auditor may decide to count the securities, although this procedure may be inconclusive due to his inability to identify them as specifically those securities belonging to his client.

It should be noted that auditors of registered investment companies are required to report in Form N-1R on their review and evaluation of internal accounting controls of the investment company which include those controls exercised on behalf of the company by agents acting as custodians. When a review of controls employed by third parties is necessary to obtain audit satisfaction, a somewhat different approach may be required from that used in reviewing an investment company's own controls, since the auditor would normally have little familiarity with overall methods of operation or with the objectives and integrity of third-party management.

Examination of Transactions and Detail Records

Custody of Securities. The independent auditor should, in all instances, obtain confirmation from the custodian of the securities in custody (including those securities held in a central securities system)[20] and from broker/dealers for unsettled security transactions whether or not reported by the custodian.

Specific inspection procedures[21] are required under the 1940 Act depending upon the type of custodial arrangement. If the custodian is a member of a national securities exchange rather than a bank, the 1940 Act and the related Rule 17f-1 provide for the inspection of all securities at the end of each annual and semiannual fiscal period by the investment company's independent auditor and at least once additionally during the fiscal year at a time chosen by such auditor without advance notification to the custodian. After each such examination the independent auditor must promptly transmit to the Securities and Exchange Commission a report stating that he has performed such an examination and describing the nature and results thereof. (Refer to Chapter 8 for sample accountant's report.)

[20] Section 17(f) of the 1940 Act.
[21] Accounting Series Release No. 27.

If the investment company is its own custodian, securities must be verified through physical inspection by the company's independent auditor at least three times during each fiscal year. The dates for at least two of these inspections shall be chosen by the auditor without prior notice to the investment company. Each examination must be covered by an auditor's report to the Commission similar to the one described immediately above.[22]

In addition to the above, securities in transfer or undelivered to or by brokers or others at the date of the examination should be confirmed. In the event a confirmation is not received, the auditor should satisfy himself as to the authenticity of the transactions, usually by inspecting subsequent liquidation.

Test of Portfolio Transactions. Rarely would the independent auditor consider it necessary to examine all transactions during the period under examination, unless specifically requested to do so by company officials. Rather, based on his evaluation of the internal accounting controls, he would normally select representative transactions for testing. For representative purchase, sale, and exchange transactions, brokers' advices or other documents should be examined to ascertain that they agree with the entries recorded in the purchase, sales, or general journals, etc. Tests should be made as to proper authorization, extensions, commission rates, taxes, trade dates, and to see that the price appears to be reasonable by reference to published sources. In addition, tests should be made to ascertain that sales have been properly accounted for during the period, i.e., that an acceptable method of costing sales (first-in, first-out, last-in, first-out, identified, or average cost) has been applied consistently and that gain or loss has been properly calculated. Where "restricted" securities are disposed of, the auditor should inquire into the compliance with Rule 144 (1933 Act) or other pertinent law.

The independent auditor should also test the classification of gains and losses for tax purposes and the adjustments made in the carrying value of investments resulting from stock dividends, splits, rights, recapitalizations, and liquidating dividends. (See Chapter 5, "Taxes.")

[22] Rule 17f-2 of the 1940 Act.

The 1940 Act or, in certain cases, the company's bylaws, limits the amount that may be invested in the securities of any one issuer. In this connection Regulation S-X requires, in prospectuses and annual reports to the Commission, the setting forth of information as to "affiliates." The financial statements or notes should state separately, where material, the investments in, investment income from, and gain (loss) from security transactions in such investments, and management or other service fees payable to controlled companies and to other affiliates. (See the glossary for definitions of "affiliated company" and "controlled affiliate.")

In ascertaining the existence of any such affiliations, the auditor should consider information obtained during the course of an audit and also make inquiries of the company's management; his working papers should include written representations from the management as evidence of such inquiries. The representations should be in the form of a statement that the company, except to the extent indicated, (1) does not own any securities either of persons who are directly affiliated or, to the best information and belief of management, of persons who are indirectly affiliated, (2) has not received income from, or realized gain or loss on sales of, investments in or indebtedness of such persons, (3) has not incurred expenses for management or other service fees payable to such persons, and (4) has not otherwise engaged in transactions with such persons. See Appendix G for an illustrative representation letter. Where there is a question as to the existence of an affiliation, a written opinion of legal counsel should be obtained by the company's management, made available to the independent auditor, and a copy included in the working papers. Venture capital companies, such as SBICs, which have many affiliations, may require special consideration as to representation letters from management.

Income From Securities. Investment income usually is comprised of dividends and interest received on investment securities. Dividends are accrued on the ex-dividend date. For tax purposes, however, dividends receivable should not be included in income until actually or constructively received. Interest is usually accrued for both financial reporting and tax purposes, except for interest on United States Treasury bills which is not included in taxable income until actually or constructively received.

Based on his appraisal of the degree of internal accounting control, the independent auditor should select an appropriate method of testing investment income. For instance, in connection with his tests of purchases and sales, he may check the related income for the securities selected for the entire year, or he may select an interim period and test the income earned during the specified period for a representative sample of securities. The auditor should consult independent financial reporting services in order to determine for the securities selected for test the ex-dividend and payable dates and the related rates. Interest payment dates and the related rates also are available from these services. Discounts on short-term "discount securities" generally are amortized in order to reflect the interest income ratably over the periods to maturity. The auditor should ascertain that significant dividend and interest receivables as of the prior audit date have been properly accounted for. In some cases, the dividends and interest may need to be reconciled for the entire year by accounting for the receivables at the beginning of the period, the amounts earned and collected during the period, and the receivables at the date of the financial statements.

In addition to the aforementioned detail testing, the auditor should pay particular attention to unusual dividends or interest received during the period under examination. For instance, dividends in arrears or defaulted interest may require special reporting or disclosure treatment. With respect to significant noncash dividends which were taken into income, the auditor should satisfy himself as to the propriety of the accounting. The auditor should review the investment schedule at the date of the financial statements and note securities which are "non-income-producing"[23] in order to disclose such data on the schedule of portfolio securities in filings with the Commission. On an overall basis, a comparison should be made of the total income in relation to assets during the period and in relation to prior period's income and an explanation should be obtained for any significant variances. For tax purposes, the taxability of dividends received during the year should be tested by reference to tax services in

[23] Rule 12-19 of Regulation S-X.

order to identify securities not eligible for the dividend exclusion and nontaxable or liquidating dividends.

Investment income from other than dividends or interest would normally require separate disclosure. Such income might be derived from gas and oil royalties or rentals. The nature and significance of such items will govern the degree of auditing required to establish that the accounting for such items is appropriate.

Valuation of Securities. At the date of the financial statements, all portfolio valuations should be substantiated. In addition, since such valuations are used in computing daily net asset value, as described in Chapter 6, they should be checked in the manner outlined below for a representative sample of dates selected from the period under examination for agreement with the values as computed by the company. The extent of these tests depends on the auditor's judgment and his evaluation of internal accounting controls.

The methods to be used for pricing investment securities will, in the usual case, be fixed in the bylaws or by action of the board of directors. In the case of registered investment companies, such methods must conform with the 1940 Act, as explained earlier in this Chapter. The independent auditor should ascertain that the valuation method utilized for determining market value coincides with the company's stated policy and, where applicable, with the rules of regulatory authorities. The methods for determining value will, of course, differ depending upon the type of security held, such as (1) securities traded on a national securities exchange, (2) over-the-counter securities, and (3) securities valued by the directors in good faith. For securities of the first two types, the auditor should refer to quotations published by a reliable quotation service (which includes NASDAQ[24]) or a financial publication in order to substantiate the valuations used for these securities. In the case of over-the-counter securities for which quotations were not available from published sources, the auditor should consider obtaining quotations as of the valuation date from more than one inde-

[24] When using NASDAQ, care should be taken to see that the names of the brokers making the quotations are given.

pendent source. An expedient in this connection is the use of a form letter showing the security description and a space where the broker, bank, or other source may place the requested "bid" and "asked" prices and his signature for return to the auditor. If the auditor is not fully satisfied with valuation date results, he may wish to obtain further quotations at a subsequent date or dates or consider having the security valued by the board of directors.

For all securities valued in good faith, the independent auditor should review the company's procedures for its continuing appraisal of such securities and ascertain that the methods established for valuation are followed and that they have been reviewed and approved currently by the board of directors. The auditor should review the procedures applied by the directors in valuing such securities and inspect the underlying documentation; he should be familiar with the provisions of Accounting Series Releases on this subject, especially ASR No. 118. This release, in commenting on the accountant's responsibility, states the following:

> In the case of securities carried at "fair value" as determined by the Board of Directors in "good faith," the accountant does not function as an appraiser and is not expected to substitute his judgment for that of the company's directors; rather, he should review all information considered by the board or by analysts reporting to it, read relevant minutes of directors' meetings, and ascertain the procedures followed by the directors. If the accountant is unable to express an unqualified opinion because of the uncertainty inherent in the valuations of the securities based on the directors' subjective judgment, he should nevertheless make appropriate mention in his certificate whether in the circumstances the procedures appear to be reasonable and the underlying documentation appropriate.
>
> When considering values assigned to securities by the company, the independent accountant should consider any investment limitations or conditions on the acquisition or holding of such securities which may be imposed on the company by the Act, by its certificate or by-laws, by contract, or by its filings with the Commission. If such restrictions are met by a narrow margin, the independent accountant may need to exercise extra care in satisfying himself that the evidence indicates that the security valuation determinations were not biased to meet those restrictions.

The "subject to" form of qualified opinion would be appropriate when an investment company's portfolio includes a significant amount of securities valued by the board of directors (using valuation approaches discussed in "Securities Valued 'in good faith'," page 35) as to which a significant range of possible value exists *and* when the independent auditor is satisfied that the procedures followed and the information obtained are adequate to enable the board of directors to value the securities. Where the *range* of possible values of such securities would not have a significant effect on the fairness of presentation of the financial statements, the auditor would be expected to express an unqualified opinion. Examples of the "subject to" form of opinion for both registered and small business investment companies appear in Chapter 8, "Independent Accountant's Reports."

If the auditor's examination discloses that the valuation procedures employed by the directors are inadequate or unreasonable, or if the underlying documentation does not appear to support the valuation, then the auditor must appropriately qualify his opinion, with an "except for" introduction, with respect to the securities carried at "fair value." The exception should relate to lack of conformity with generally accepted accounting principles.

Perhaps a useful rule of thumb for taking exception would be that when the auditor cannot make the positive representations found in the explanatory middle paragraph of the recommended "subject to" opinion then an "except for" opinion is appropriate as to all or a significant portion of the securities being valued. Where circumstances warrant, a disclaimer of opinion or an adverse opinion also may be appropriate.

Chapter 4

Capital Accounts

This chapter deals principally with the operations, controls, accounting, and auditing of the capital accounts of open-end companies. In most respects, the capital accounts of closed-end companies can be accounted for and audited similarly to other commercial enterprises.

OPERATIONS, CONTROLS, AND ACCOUNTING PRINCIPLES

Distributor Organization

As mentioned in Chapter 1, a separate distributor (often referred to as the principal underwriter) organization performs the selling function for a load fund, while a no-load fund generally sells its shares directly to the public. Distribution organizations vary somewhat in their manner of operation, and, therefore, the accounting control requirements will vary. Wholesale distribution organizations sell shares through retail broker/dealers who, in turn, retail the shares to individual investors. Retail distribution organizations sell shares directly to the individual investors, frequently selling only the funds offered by a single distributor. In wholesale distributions the sales commission (load) is divided between the distributor and the broker/dealer, while in retail distributions the distributor retains the entire commission. In each of these transactions a portion of the commission is paid to the salesman actually making the sale of shares. The salesman may be an employee of the distributor or of the retail broker/dealer, or be an independent contractor. Some distributors act as principal in the sales transaction, buying the shares from the fund and, in turn, reselling these shares to the investor or to the broker/dealer. Other distributors act as agents in the sales transaction, the actual sale being made directly from the fund to the investor or to the broker/dealer.

Commissions

Sales commission rates on mutual funds generally are based on the size of the sale, with the rate of commission declining as the amount of the sale increases. Some funds offer a "letter of intent," "right of accumulation," or other arrangement whereby a purchaser will be entitled to a lesser sales charge based on his aggregate purchases of fund shares, even though his separate purchases would not qualify for such reduced sales charge.

The investor signing a letter of intent indicates his intention to purchase the specified amount over a period of time (generally 13 months) and agrees to pay the applicable higher sales commission if he does not complete the letter of intent. Generally, enough shares are held in escrow by the principal underwriter or transfer agent during the letter of intent period to cover any subsequent adjustments for increased sales commissions which may arise if the letter commitment is not completed. In the event the letter is not completed, the investor is required to pay the increased sales commission or the escrowed shares may be sold in an amount sufficient to pay such commissions.

Under right of accumulation arrangements, a purchaser making subsequent investments includes the value of shares currently owned to determine the sales charge of such subsequent investment.

Orders to Purchase or Repurchase[1]

Orders to purchase mutual fund shares are originated by the broker/dealer contacting the mutual fund distributor by telephone or wire (commonly referred to as a wire transaction) or, especially in the case of an individual investor, by mailing (or actually delivering) an order and check to the fund or its agent. In each case the sale is made at the time the distributor or its agent accepts the order.[2] Orders for the repurchase of shares are similarly handled. Orders received which are not accompanied by cash payment or stock certificates require settlement within the normal period for settling such transactions. Acceptance of orders is predicated upon satisfactory credit checks and compliance with qualification requirements of the various states (Blue Sky laws).

When an investor purchases shares of a mutual fund, he usually has the choice of receiving a stock certificate (outright or certificate sale) or having the transfer agent hold "book shares" on deposit in his name (open account plan or accumulation account sale). Generally stock certificates are issued only in whole share amounts, while book shares may be maintained in fractional shares.

Investors buy at an offering price which, with respect to load funds, includes net asset value and a load factor (commission). Investors redeem generally at net asset value, although some funds or their managers charge a redemption fee, which, to the extent received by the fund, is usually credited to capital. Sales or repurchase orders accepted by the fund or its agent are executed at prices based on the first per-share net asset value computed after acceptance of the order (forward pricing) and are time-stamped at time of receipt to substantiate the applicable price. Copies of the confirmation form are prepared for internal record-keeping purposes and for mailing to the investor.

Accurate recording of sales and repurchases of fund shares is predicated upon the adequacy of controls over order information by the distributor, the company, and the transfer agent.

[1] The terms "repurchase" and "redemption" are used interchangeably in this guide.
[2] Rule 22 c-1 of the 1940 Act.

Important internal accounting controls over order tickets are (1) proper cutoff based on time-stamping; (2) check of the arithmetical accuracy of individual order ticket data; and (3) review of the relationship of daily sales and repurchase of shares to total dollar amounts. The accuracy of the information included on the order ticket with respect to the investor and the number of shares is in large part dependent upon the reliability of the information supplied by the distributor.

Sales and repurchase journals are maintained to record the basic accounting data concerning the transaction. In addition, the sales journal may contain data relating to (1) source of order by dealer (generally load funds only), (2) sales statistics by area, size of order, etc., and (3) sales statistics to meet Securities and Exchange Commission disclosure requirements and state Blue Sky regulations.

Cancellation of Orders

Occasionally sales or repurchases may be cancelled by an investor or broker/dealer prior to the settlement date. Any fluctuation in net asset value per share between the sales date and the cancellation date would result in a gain or loss to the fund if the transactions were simply reversed. Where a distributor is involved, it should bear, or collect from the broker/dealer, any loss arising from such cancellation. If the cancellation results in a gain, that gain may be accrued by the fund to offset any future losses but may not be paid to the distributor. In those cases where a fund sells its shares directly to investors, it should consider refusing to accept sales orders unless accompanied by payment or refusing to accept orders for repurchases unless accompanied by properly endorsed stock certificates (or written requests in the case of "book shares"), unless indemnified by a responsible person against failure to complete the transaction.[3]

Stock Transfer Function

Because of the continuing sale and repurchase of fund shares, the stock transfer function is an integral part of mutual fund operations and is more complex than that of the usual commer-

[3] 1940 Act Release No. 6366 and instructions to Item 2.24 of Form N-1R.

cial enterprise. The records must be kept current at all times with respect to the total shares outstanding, the total shares issued since inception, and also as to detailed shareholder accounts. The mutual fund stock transfer function is performed generally by one of three types of agents: (1) an affiliated company of the fund's manager or distributor ("in house" operation); (2) the separate department of a bank; or (3) an independent service bureau. In all cases the basic operations are the same; however, depending on the type of agent, the methods used by the fund or its manager to control the stock transfer function vary.

In those cases where sale and redemption orders are sent by the investor directly to a transfer agent, the fund and its distributor are dependent upon information obtained from a daily statement prepared by the transfer agent in order to record these transactions in their respective records. The transfer agent's daily statements sent to the fund show the day's activity both in shares and dollars. These statements must be reconciled to the fund's records and any differences promptly identified and satisfactorily accounted for. A significant difference in number of shares outstanding could affect net asset value per share if the fund's records were in error.

Cash in settlement of transactions, whether received by the fund, its distributor, or its transfer agent, is forwarded to the depository bank. In the case of redemptions, disbursements are generally made by the transfer agent to the investor or broker/dealer. Under arrangements where the distributor and fund do not handle cash, the fund is dependent upon the transfer agent to provide information as to paid and unpaid sales and repurchases. Either the transfer agent or the fund manager, depending upon the particular arrangement, must follow up on delinquent accounts receivable and unpaid repurchase orders.[4]

The fund should determine that the number of outstanding shares shown on the fund's general ledger and the transfer agent's control account are in agreement, and that the detailed shareholder accounts are posted on a current basis. Items which require close attention include transactions in the control ac-

[4] Refer to National Association of Securities Dealers (NASD) rule regarding settlement of securities transactions.

count which have not yet been applied to the detail shareholder accounts (suspense accounts) as well as errors in posting to individual shareholder accounts, including wrong accounts. In order to maintain proper control over these areas, it may be necessary for the fund to perform periodic on-site reviews of the transfer agency operation in addition to a continuous monitoring function. This review should include, among other things, an inspection of the shareholder correspondence and inquiry file which must be maintained by the company or its transfer agent. A significant volume of letters may indicate problems in the detailed shareholder accounts.

An important function usually performed by the transfer agent is the distribution of dividends from investment income and of net realized gains from securities transactions. An investment company shareholder generally has the option to elect that such distributions be made either in cash or in additional shares of the company. Tax withholding on certain distributions is required for non-United States shareholders by Internal Revenue Service regulations. In addition to the above distribution function, the transfer agent is generally responsible for preparation of annual dividend taxability notices mailed to all shareholders. Information relative to the foregoing must be transmitted to the transfer agent properly and timely to insure appropriate handling. Even relatively small companies may have several thousand shareholders, so any communication with such shareholders, including dividend transactions, is a major task.

Accounting for treasury stock is of significance in commercial enterprises and in certain instances to closed-end investment companies; however, it is of less importance to mutual funds because only the number of shares outstanding has relevance in the financial statements. The number of shares previously repurchased by a fund is important only in connection with certain legal requirements of regulatory authorities. The Securities and Exchange Commission as well as various state authorities have stringent requirements regarding registration of shares which are sold in their respective jurisdictions. Therefore, it is important that the fund keep adequate records of the number of shares registered and both dollar amounts and number of shares sold in various jurisdictions.

The 1940 Act[5] specifies certain record-keeping requirements and the Securities and Exchange Commission's staff periodically inspects these records for compliance.

Accounting for Capital Share Transactions and Distributions

Accounting principles for shareholder accounts of mutual funds are generally the same as those for commercial enterprises. Bookkeeping entries to record sales of fund shares are made daily by debiting either cash or accounts receivable and crediting capital stock for the par value of the stock to be issued and additional paid-in capital for the excess amount paid over the par value. The recording of a repurchase requires a debit to the capital stock and additional paid-in capital accounts and a credit to either cash or accounts payable. As more fully discussed in Chapter 2, some funds employ equalization accounting in which a portion of the proceeds from sales and costs of repurchases of shares, equivalent to the amount on a per-share basis of distributable net investment income on the date of the transaction, is applied to equalization credits and debits to retain the same per-share amount of undistributed net investment income.

Investment income and realized gains on securities transactions are generally accumulated in separate accounts, as are distributions thereof. The accurate recording of the dividend and distribution amounts is dependent, among other things, upon the proper recording of the outstanding shares.

Accounting for distributions (including both investment income dividends and distributions of realized gains from securities transactions) begins with the declaration of the distribution. Because of the significance of the relationship between net asset value and market price of the company's stock, most closed-end investment companies record the dividend liability on the ex-distribution date, rather than on the declaration date. Open-end companies must record the liability on the ex-distribution date in order to properly state the net asset value at which sales and redemptions are made. If investment companies offer their

[5] Section 31 and Rule 31a-1 of the 1940 Act.

shareholders the right to reinvest a distribution (i.e., receive the distribution in additional shares), such shareholders must notify the company (sometimes by positive action and sometimes by inaction) of their intention to accept cash or to have such distribution reinvested. For those who indicate their intention to have such distribution reinvested a "valuation date" is established by the company. This date should be on or after the date by which the shareholder's intention must be made known to the company. For closed-end companies who issue shares and for open-end companies issuing shares at net asset value, the valuation date is the point at which recognition in their accounts of the issuance of additional shares must be made. The payment date is significant for those who accept the distribution in cash, thereby eliminating the liability of the investment company, but the valuation date is of paramount importance to those electing to have the distribution reinvested in additional shares. At the valuation date, the number (actual, or if necessary, estimated) of shares to be issued on the payment date and the price per share are set; thenceforth the total net assets will reflect the total dollars reinvested and the additional shares outstanding resulting from the distribution reinvestment.

AUDITING PROCEDURES

The audit of the capital accounts ("shareholder accounting") for a mutual fund is a broad area encompassing various aspects of transactions with shareholders. The audit objectives within the shareholder accounting area are to ascertain that—

1. Procedures are satisfactory for determining the number of outstanding shares used to compute daily net asset value per share which serves as the basis for pricing sales and redemptions of fund shares.
2. The number of outstanding shares of capital stock at the examination date is correct and in agreement with the transfer agent records, and the shares have been properly registered under the 1933 Act.
3. The receivable for capital stock sold and the payable for capital shares redeemed are properly stated.

4. Dividends from investment income and distributions of net realized gains from securities transactions to shareholders and reinvestments thereof are properly computed and accounted for.
5. Procedures are satisfactory for maintaining adequate controls over the record keeping for indvidual shareholder accounts.

Review of Internal Accounting Controls and Procedures

At the outset of his examination, the independent auditor should familiarize himself with (1) the rules and regulations under the 1940 Act which cover shareholder accounting, including pricing of fund shares and record-keeping requirements; (2) the fund's current prospectus which states the fund's policies for accepting sales orders and redemption of fund shares; (3) items of Form N-1R which deal with sales and redemptions and with dividends and distributions; (4) provisions of the agreement between the fund and those responsible for the stock transfer function; and (5) state Blue Sky requirements.

As in all audits, a review and evaluation of internal accounting controls should be made prior to making detailed tests of transactions and records. In addition, the independent auditor should review the operating procedures and controls of the stock transfer function, whether done by the fund, its affiliate, or by outside agents. Discussions should be held with company and/or agency personnel to ascertain procedures for and controls over processing sales, repurchases, reinvestments, payment of dividends and distributions, letters of intent, rights of accumulation, collection of sales and repayment for repurchases, cancellation of sales and repurchases, and accounts which have not made additional investments for a period of time. It should be ascertained that such procedures are satisfactory to promptly furnish the fund and/or its agent with necessary information required to properly process its shareholder records as required by the 1940 Act.[6] In this connection, it should be noted that independent auditors of registered investment companies are required to report in Form N-1R on their review and evaluation of internal accounting controls of the

[6] Rules 2a-4 and 31a-1 of the 1940 Act.

investment company, which include those controls applicable to the transfer function whether carried out by the investment company or its agent. When a review of controls employed by third parties is necessary to obtain audit satisfaction, a somewhat different approach may be required from that used in reviewing an investment company's own controls. The auditor would normally have little familiarity with overall methods of operation, or the objectives and integrity of third party management and quite likely would require a more intensive review of controls in such a situation. Auditing procedures relative to evaluation of internal accounting controls are discussed in the next section.

Examination of Transactions and Detail Records

Sales and Repurchases of Fund Shares. Based upon his evaluation of internal accounting controls, the independent auditor should select representative transactions throughout the examination period to test sales and repurchases of capital shares. The independent auditor should determine that details on the order form or other customer evidence used in writing up the sale or repurchase agree with the copy of the confirmation form, which is ultimately sent to the shareholder confirming the sale or repurchase. Such tests should also determine that these transactions are in accordance with the fund's policy. Specifically, the independent auditor should determine that order forms are (1) time-stamped at time of receipt; (2) properly priced based on net asset value next computed; (3) checked for Blue Sky qualification; (4) approved for credit; and (5) rechecked and approved by a second individual.

On a test basis, totals of daily sales and repurchases of capital shares should be compared to postings in the related journals. Capital stock outstanding for days tested should be compared to the applicable daily net asset valuation worksheets which were used as the bases for computing the net asset value per share. It may also be desirable to obtain confirmation from shareholders of specific transactions where considered warranted under the circumstances by the independent auditor.

Settlement of Sales and Repurchase Transactions. The independent auditor should satisfy himself that collections of receivables for shares sold and payment for shares repurchased are made on a timely basis in accordance with the regulatory requirements. The tests of timely collection and payment for shares sold or repurchased are important inasmuch as Form N-1R[7] requires the independent auditor to state his opinion on answers to certain questions relating to these areas. Subsidiary trial balances of receivables and payables should be agreed to general ledger control accounts as of the examination date. Determination also should be made of the timely cancellation of sales and repurchases not settled within a specified time and of the disposition of the resultant loss, if any. Disposition of losses must be reported in Form N-1R.

Reconcilement of Shares Outstanding. The independent auditor should substantiate on a test basis that, throughout the examination period, the fund has reconciled its general ledger account for outstanding shares with reports of the transfer agent and satisfactorily resolved all reconciling items. Where warranted under the circumstances, the independent auditor should examine the underlying support for the reconciling items to the extent he considers necessary. Early recognition of any problems in this area may avoid delays in completion of the examination.

At the examination date, the independent auditor should obtain a confirmation of shares outstanding directly from the transfer agent and determine that it has been reconciled with the outstanding shares shown in the fund's records.

The independent auditor may, in certain instances, consider it desirable or necessary to confirm outstanding shares directly with the shareholders.

Dividends and Distributions to Shareholders and Reinvestments. Amounts of dividends from investment income and distribution to shareholders from realized gain on security transactions are related to outstanding capital stock and tests should be made to determine that payments, whether in cash or additional capital stock, have been properly computed. Distribution

[7] Items 2.24 and 2.25 of Form N-1R.

of long-term realized gains from security transactions may not be made more than once a year, except that a supplemental distribution of up to 10 percent of the original distribution may be made. The portions of the 1940 Act[8] dealing with dividends and distributions should be reviewed to ascertain compliance with the Act. The independent auditor should review board of directors' minutes for relevant dates and amounts of dividend and distribution declarations and ascertain that outstanding shares according to the fund's records on such date (ex-dividend date for open-end companies) have been reconciled to information reported by the transfer agent. The total dividend and distribution should be recomputed (outstanding shares times rate) and compared to notification from the dividend disbursing agent (usually same as the transfer agent). The liability for each dividend should be traced to the general ledger and to the applicable daily net asset valuation worksheet to ascertain that the liability was recorded on the proper date. The computation of the number of shares to be reinvested as reported by the dividend disbursing agent should be checked and the portion of the dividend and distribution taken in shares should be compared to the capital stock accounts for both number of shares and dollar amounts.

Record Keeping for Individual Shareholder Accounts. Based on his evaluation of internal accounting controls with respect to the transfer agent or shareholder servicing agent, the auditor may wish to select representative accounts and test for the validity and proper documentation of transactions, especially as to name and address changes, share transfers to or from individual accounts, and other transactions not of a routine nature. Particular consideration should be given to accounts which have not made additional investments for a period of time, or for which mail has been returned undelivered. The auditor may deem it desirable with respect to such accounts to obtain from shareholders confirmation of their account status.

Other Matters. Where equalization accounting is in effect, tests should be made to determine that equalization debits and

[8] Section 19 and Rules 19a-1 and 19b-1 of the 1940 Act.

credits have been properly computed. (See Chapter 2 for a discussion of equalization accounting.)

Complaints by shareholders evidenced in writing, either at the fund's office or the transfer agent premises, recorded in an appropriate record, should be reviewed on a test basis. A significant volume of complaints reflecting on pricing or incorrect calculations of shares issued may indicate that the independent auditor should extend his tests.

The independent auditor should review schedules of sales of shares by state, maintained by the fund in connection with Blue Sky law compliance.

The independent auditor may wish to confirm balances receivable for capital stock sold directly with the investor or the dealers who are selling the fund's shares as well as the balances payable for capital shares to be redeemed by the fund. Where considered necessary, details of specific capital stock transactions may also be confirmed at this time. Other normal alternative auditing procedures may be utilized to satisfy the auditor as to the receivable and payable for fund shares sold and redeemed.

The representation letter received from management should include a statement that fund shares were sold and redeemed in accordance with the fund's prospectus and rules and regulations of the Securities and Exchange Commission and state securities regulations.

Chapter 5

Taxes

Investment companies are subject to federal income taxes and certain state and local taxes, as are other domestic business entities. Most investment companies registered under the 1940 Act may qualify for special tax treatment under the Internal Revenue Code. This chapter describes in general terms the effects of, and requirements for, qualification as a "regulated investment company" and certain other federal income tax matters affecting investment companies.[1] State and local taxes are beyond the purview of this chapter, as are tax aspects of "offshore funds."

Certain unit investment trusts[2] issuing periodic payment plans (contractual plans) are not regarded as separate taxable entities. The planholders are treated as owning a proportionate share of the assets in the trust.

INTERNAL REVENUE CODE REQUIREMENTS

Effect of Qualification

The effect of qualification as a "regulated investment company" is to permit investment income and capital gains to flow through the investment company to its shareholders without the

[1] Subchapter M (Sections 851 to 855) of the Internal Revenue Code (IRC).

[2] Section 851(f) of the IRC.

investment company paying federal income taxes thereon. Further, the shareholder receives a favorable tax treatment. Dividends from investment company taxable income will qualify[3] for the dividend received exclusion available to individual taxpayers and the dividend received deduction in the case of corporate taxpayers. Such dividends are subject to proportional reduction in computing the dividend received exclusion or deduction if the qualifying dividends received from domestic corporations amount to less than 75 percent of the investment company's gross income as defined.

Requirements for Qualification

To qualify as a regulated investment company for tax purposes, set forth more fully in the Code, an investment company generally must—

1. Be a domestic corporation, other than a personal holding company,[4] registered at all times during the taxable year under the 1940 Act.
2. Elect to be taxed as a regulated investment company, or have previously made such election.
3. Derive at least 90 percent of its gross income from dividends, interest, and gains (disregarding losses) from the sale or other disposition of securities.
4. Derive less than 30 percent of its gross income from gains (disregarding losses) on the sale or other disposition of securities held for less than three (3) months.
5. Meet certain requirements as to diversification of its total assets at the close of each quarter of the taxable year.
6. Pay out at least 90 percent of its investment company taxable income (as defined) for the taxable year.
7. Comply with certain record-keeping and notification (to shareholders) requirements in addition to the records required of ordinary corporations.

[3] Section 852(b)(2) of the IRC.
[4] Section 542(a)(2) of the IRC.

Certain of these items are discussed in more detail in the following sections of this chapter. A worksheet such as the one included as Appendix B may be used by a company to ascertain and document that it has complied with certain of the requirements for qualification.

An election to be a regulated investment company is made by computing taxable income as a regulated investment company in the company's return for the first taxable year for which the election is applicable. Once made, the election is irrevocable for that year and all succeeding taxable years as long as the company qualifies.

In calculating the 90 percent of gross income limitation, certain items are given special treatment. Amounts derived from writing "put" and "call" options which have lapsed do not constitute gains from the sale or other disposition of stock or securities within the meaning of the Internal Revenue Code and thus are excluded from the 90 percent portion. Interest on state, county, or municipal obligations is not included in gross income. Income of an unusual nature, such as amounts recovered as a result of settlements of litigation, should be given special attention (which may require consultation with the Internal Revenue Service) as to tax status and effect on the 90 percent gross income limitation.

At the close of each quarter of the taxable year, in order to meet the diversification requirements, at least 50 percent of the value of the company's total assets must be represented by cash and "cash items," government securities and securities of other regulated investment companies, and "other securities." For the purpose of this requirement, investments in the securities of any one issuer which are greater in value than 5 percent of the total assets of the investment company or represent more than 10 percent of the outstanding voting securities of such issuer cannot be included in "other securities." Furthermore, to meet diversification requirements, no more than 25 percent of the value of the company's total assets may be invested in the securities (other than United States Government securities or the securities of other investment companies) of any one issuer, or of two or more issuers which the regulated investment company controls (20 percent or more of combined voting power) and which are engaged in the same or similar trades or businesses or related trades or business.

A regulated investment company which meets investment diversification requirements at the close of one taxable quarter will not lose its status if it fails to satisfy these requirements in a later taxable quarter, provided the noncompliance is not due in whole or in part to the acquisition of any security or other property. If, as a result of an acquisition, an investment company fails to meet the diversification requirements, it may reestablish its status as of the beginning of the quarter by eliminating the discrepancy within 30 days after the close of the quarter. The calculation of diversification can be quite complicated and care should be taken to understand the rules as prescribed by the Code and Regulations thereunder.

An exception to the requirements for diversification of assets is made for an investment company that furnishes capital for corporations chiefly engaged in developing new products, i.e., a "venture capital" company. To qualify, the investment company must have the Commission certify, not earlier than 60 days before the close of the taxable year, that it is principally engaged in the furnishing of capital to other corporations which are principally engaged in the development or exploitation of inventions, technological improvements, new processes, or products not previously generally available. If Commission certification is obtained, both the 10 percent of voting power test and the 5 percent of value test, discussed on the previous page, are waived for purposes of determining compliance with the requirement for 50 percent diversification of investments.

A regulated investment company may elect (on Form 2438), within 30 days after the close of the fiscal year, to retain and pay federal income tax on behalf of its individual shareholders on net long-term capital gains realized by it during the taxable year. As a practical matter, the decision to elect must be made before year-end in order to meet accounting requirements (net asset value computation) for recognizing the liability as at year-end. Shareholders are required to report in their income tax returns, as long-term capital gains, their proportionate share of these undistributed long-term capital gains "designated" by the investment company. The shareholder may claim credit on his individual federal income tax return for the taxes paid on his behalf. The tax basis of his shares is increased by the difference between the amount of the undistributed long-term capital gains included in his tax return and the applicable amount of the corporate capital gains tax taken as a tax credit.

To the extent that a regulated investment company does not distribute all of its investment income (even though it meets the 90 percent test) it must pay corporate income tax on the undistributed portion. Similarly, if the company fails either to distribute realized capital gains or to designate such gains to the shareholders (as discussed in the preceding paragraph), the company would be subject to tax on such gains as would an ordinary corporation.

An open-end investment company may, as discussed in Chapter 2, employ equalization accounting in appropriate circumstances. For tax purposes, equalization credits are treated as "Schedule M" items and are not included in net investment income; on the other hand, equalization debits are often treated as dividends paid for ascertaining that at least 90 percent of net investment income has been distributed to shareholders.

A regulated investment company may designate as being applicable to the prior taxable year all or part of any dividends, including capital gains distributions, which are declared after the end of its taxable year. Such declaration must be made before the due date for the filing of the corporate return, including any extension. Such dividends or distributions must be paid in the 12 months following the close of the taxable year and not later than the date of the first regular dividend payment made after such declarations.

Within 45 days after the close of its taxable year, a regulated investment company must notify its shareholders (Form 1099M is often utilized by calendar year companies for this purpose) regarding the portion of distributions made within such taxable year which represents capital gain dividends and the portion it treats as ordinary income dividends (as well as "qualifying" dividends) and, on Form 2439, where appropriate, the amount of long-term gains retained and taxes paid thereon. Shareholders are taxed in the year in which dividends or distributions are received by them.

A regulated investment company is prohibited from claiming a net operating loss deduction. On occasion, especially with newly formed investment companies, a company may incur a net operating loss which it cannot utilize if it elects to be a regulated company in the succeeding year(s). In such cases, the company may choose not to elect to be taxed as a regulated company in order to realize the benefit of the carryover loss.

A net capital loss may be carried forward by a regulated company to the five succeeding taxable years but may not be carried back to any of the three preceding years in which the company qualified as a regulated company. In the case of a nonqualified company, the loss may be carried back three years and forward five years.

If an investment company has available a capital loss carryover and distributes to shareholders net capital gains realized in the current year, all or a portion of that distribution equal to the amount of the carryover may be taxed to shareholders at ordinary income rates. This would be because distributions during a year are taxable as ordinary income to the extent that there are "earnings and profits," as defined for federal income tax purposes, earned during that year.

Permanent records must be maintained of the actual ownership of the stock of the investment company to indicate that it is a regulated investment company and not a personal holding company.[5] Sufficient records are required as to investments to show that it has complied with the investment diversification requirements during the taxable year.

Failure of a regulated investment company to meet all the Internal Revenue Code requirements in any taxable year will result in its taxation as an ordinary corporation for that year.

Other Considerations

Dividends and Interest. For accounting purposes, dividend income is recorded on the ex-dividend date. However, for tax purposes it should be reported when actually or constructively received.

Where a dividend or other distribution received by the com-

[5] See Regulation 852-6 under the IRC for notification procedures required.

pany represents a return of capital, it reduces the basis of the security for purposes of computing gain or loss for tax purposes. For accounting purposes, such distributions may represent, at least in part, a recovery of cost.

Interest income is taxable to an accrual basis company when earned. Short-term obligations of the United States (Treasury bills) and other governmental bodies, issued on a discount basis, are payable at face amount at a fixed maturity date not exceeding one year from the date issued; the amount of the discount is not taxable until the date on which such obligation is paid at maturity or sold, irrespective of the method of accounting used by the company. As to other short-term obligations issued at a discount, the discount is interest, and is taxable as earned over the life of the obligation.

Sales of Securities. When securities are sold or disposed of, their cost may be either specifically identified or determined on a first-in, first-out basis; average cost is not acceptable for tax purposes. An acceptable means of specific identification is to show that certificates representing shares of stock from a lot which was purchased or acquired on a certain date for a certain price were delivered. Where the stock is left with a custodian bank or in the custody of a broker or other agent, an acceptable specific identification is made if the agent is instructed as to what particular block of stock (i.e., date of purchase, name of broker from whom purchased, unit price) is to be sold and within a reasonable time thereafter, confirmation of such sale (preferably referring to the "specifications") is set forth in a written document received from such agent. Irrespective of the specifications, the agent can deliver stock from any lot.

Commissions related to the purchase or sale of securities are not deductible but are an addition to cost or an offset against the selling price.

A wash sale exists when, within a period beginning 30 days before the date of a sale of securities and ending 30 days after such date (a 61-day period), the investment company acquired or entered into a contract to acquire substantially identical securities. A loss resulting from such a transaction is recorded as a loss for accounting purposes but is not a deductible loss for tax purposes; the tax basis of the new security purchased is increased by the amount of the loss and the holding period of the original position remains unchanged. A gain on such transactions is taxable.

A short sale is one in which the seller borrows the stock certificates or other property delivered to the buyer. For tax purposes a short sale is not deemed to be consummated until delivery of equivalent property to the lender occurs, which closes the short sale. Long-term gain or loss results only if the property delivered to close the short sale had been held more than six months prior to the short sale.

Bond Discount and Premium. "Original issue discount" (relating to long-term obligations) is the difference between the issue price and the stated redemption price at maturity. (Original issue discount which is less than one-quarter of one percent of the redemption price at maturity multiplied by the number of complete years to maturity, is not considered to be "original issue discount" for tax purposes.[6]) Such a discount must be amortized on a ratable basis over the life of the issue by the original holder. In case of subsequent holders the amount to be amortized is the lesser of the unamortized "original issue discount" or the difference between the cost to the subsequent holder and the amount to be received at maturity. All other discounts may not be amortized for tax purposes.

Amortization of bond premium is required for tax purposes for fully tax-exempt and partially tax-exempt bonds and may be taken for fully taxable bonds.

When bonds are purchased "flat," interest subsequently received which relates to the period prior to purchase is not taxable income but is a return of capital.

Put and Call Options. A "put" is an option, bought at a price (premium), giving the holder the right to sell a given number of shares of stock to the option writer at a specified price within a certain time. A "call" (which is a "put" in reverse) is an option, bought at a premium, to buy a certain number of shares from the writer within the prescribed time limit at the price stated in the option. If the holder of a put exercises his option, the

[6] Section 1232(b) of the IRC.

capital gain or loss on the sale is adjusted by the premium and the writer deducts the premium from the cost basis of the stock. If the holder of a call exercises his option, the amount paid to the writer is included in the holder's total cost basis and the gain or loss to the writer on sale is adjusted by the premium. If either a put or a call option is not exercised, the holder realizes capital loss (long-term or short-term, depending on the holding period) and the writer realizes ordinary income.

A "straddle" option is a simultaneously granted combination of an option to buy (a "call") and an option to sell (a "put") the same quantity of a security at the same price during the same period of time. The premium received is generally allocated between the call and the put according to respective market values of the individual options. When one or both of the options in the straddle is allowed to lapse, the amount realized by the writer (grantor) on the portion of the premium allocated by him to that option is treated by him as a short-term capital gain. The tax treatment by the buyer of all or part of a straddle is the same as that described in the preceding paragraph.

Stock Issuance Expenses. Stock issuance expenses may be paid by the company, its underwriter, or others. Such stock issuance expenses if paid by an open-end fund, except those incurred during the initial stock offering period, are deductible as an expense.[7] See Chapter 6, "Registration Fees and Expenses" for further discussion of registration fees and expenses and the accounting therefor.

Foreign Tax Credit. A regulated investment company may elect to have its foreign tax credit passed through to its shareholders if more than 50 percent of the value of its total assets at the close of the taxable year consists of stock or securities in foreign corporations and it has distributed at least 90 percent of its investment company taxable income.

Small Business Investment Companies

A small business investment company operating under the Small Business Investment Act of 1958 receives special tax treat-

[7] Section 162(a) of the IRC and Revenue Ruling 72-13.

ment. The effect is to allow certain exclusions or additional deductions without the limitations prescribed for other corporations.

A small business investment company operating under the 1958 Act is allowed a 100 percent dividends received deduction for dividends received by it from a taxable domestic corporation.[8] To claim this 100 percent deduction the company must file with its return a statement that it was a federal licensee under the 1958 Act at the time of the receipt of the dividends.

An ordinary loss, rather than a capital loss, can be taken on the sale or exchange of security investments in convertible securities or stocks issued due to conversion privileges. Capital losses on other investments receive no special treatment.[9] The company must submit with its tax return a statement that it is a federal licensee under the 1958 Act and it also must set forth the name and address of the small business concern with respect to whose securities the loss was sustained, the number of shares of stock or the number of denomination of bonds, the basis and selling price, and the respective dates of purchase and sale or the reason for their worthlessness and the approximate date thereof.

Special provisions are provided for reserve for losses on loans of small business investment companies.[10] A small business investment company may obtain special treatment for net operating losses[11] and may be excluded from the definition of a personal holding company.[12]

A shareholder in a small business investment company may treat a loss on such stock as an ordinary loss[13] and in the case of a non-corporate shareholder such loss is considered a loss from a trade or business.[14]

Personal Holding Companies

A personal holding company cannot qualify as a regulated investment company. Two basic tests are applied in determining

[8] Section 243(a)(2) of the IRC.
[9] Section 1243 of the IRC.
[10] Section 586 of the IRC.
[11] Section 172(b)(1)(E) of the IRC.
[12] Section 542 (c)(8) of the IRC.
[13] Section 1242 of the IRC.
[14] Section 172(d)(4) of the IRC.

whether a corporation is a personal holding company: (1) the type of income test and (2) the stock ownership test. Regulated investment companies usually meet the "type of income test," since most of their income is generally passive, i.e., dividends and interest. Therefore, it is essential that companies consider carefully the consequences of "stock ownership" as described below.

Under the stock ownership test,[15] a corporation is considered a personal holding company if at any time during the last half of its taxable year more than 50 percent in value of its outstanding stock is owned, directly or indirectly, by or for not more than five "individuals." For purposes of Section 542(a)(2) certain tax-exempt organizations, including charitable organizations and trusts created under "qualified" pension, stock bonus or profit-sharing plans, are treated as "individuals." Corporations, other than the tax-exempt organizations, are not considered to be "individuals" but, rather, the number of shareholders of the corporation must be considered. A failure to avoid personal holding company status would subject the company to regular corporation income tax rates and also expose it to the imposition of the punitive personal holding company tax which is based on undistributed personal holding company income.

A company claiming regulated investment company status must maintain permanent records showing certain information on the actual ownership of its stock as contained in written statements of its shareholders so that the fund can demonstrate to the Internal Revenue Service that it is not a personal holding company.[16]

AUDITING PROCEDURES

The principal concern of the auditor in the area of taxes is to satisfy himself that the investment company which elects to be treated as a "regulated investment company" is in fact qualified for such treatment. Since failure to meet *all* requirements for qualification will result in the company being taxed as an ordi-

[15] Section 542(a)(2) of the IRC.

[16] Regulations 852-6 and 852-7 under the IRC.

nary corporation, this is an extremely important area for the auditor to consider early in his examination.

Earlier in this chapter several of the more significant requirements were discussed, but the auditor should refer to the Internal Revenue Code[17] in designing his detailed audit program to cover all aspects of qualification. As to some of the record-keeping and notification requirements, the audit work may involve only inquiry of the client and inspection of correspondence with the transfer agent and shareholders. Other requirements can be tested with simple worksheets. For example, the requirements for qualification discussed on page 63 can be tested using a worksheet similar to that in Appendix B.

[17] Section 851 of the IRC.

Chapter 6

Other Accounts and Considerations

This chapter includes comments on accounts and matters peculiar to investment companies which are not discussed fully in other chapters. The independent auditor should assume that investment company accounts not specifically mentioned in this audit guide will ordinarily be maintained in accordance with generally accepted accounting principles and audited in accordance with generally accepted auditing standards for other commercial enterprises.

Net Asset Value Computation

The importance of net asset value has been discussed in previous chapters. To properly report shareholders' equity, securities must be valued and income and expense accruals made at least as often as a company issues information concerning net asset value. Although registered closed-end investment companies do not issue redeemable securities, and although not specifically required, net asset values are often computed on a regular periodic basis. With respect to registered open-end investment companies, and certain closed-end companies, the price make-up sheet (computation of net asset value per share) usually is prepared daily, giving due consideration to the following items:[1]

1. Portfolio securities valuation calculated as discussed in Chapter 3.
2. Changes in investments included no later than the first calculation of net asset value on the first business day following the trade date.
3. Changes in the number of outstanding shares of the investment company resulting from sales, distributions, and repurchases—included no later than the first calculation of net asset value on the first business day following such change.
4. Expenses (including investment advisory fees)—accrued to date of calculation. Federal income taxes payable on security gains that the investment company elects to retain are accrued only as of the close of the fiscal year.[2] Customarily, the company estimates its expenses for the year as well as the period within which such expenses will fall, and reflects these expenses in the net asset value computation pro rata on a periodic basis, generally daily. The estimated annual expenses should be reviewed continually and the accruals adjusted as required.
5. Dividends receivable—recognized at ex-dividend dates.
6. Interest income and other income—included to date of calculation.

The foregoing are typically encountered in the computation of the net asset value; however, other aspects of accrual accounting peculiar to investment companies, discussed elsewhere in this and other chapters of the guide, must be considered. Any expense and/or income items (excluding dividends) need not be accrued daily if cumulatively, when netted, they do not amount to as much as one cent ($.01) per outstanding share.[3] Dividends and distributions payable, as indicated in Chapters 2 and 4, are accrued on the ex-dividend and ex-distribution dates.

[1] Rule 2a-4 of the 1940 Act.
[2] Accounting Series Release No. 114.
[3] Rule 2a-4(b) of the 1940 Act.

The independent auditor's review of the net asset value computation as shown on the company's price make-up sheets, at the date of the financial statements and at selected interim dates, should include the following procedures:

1. Compare the quantities and descriptions of portfolio securities owned to the investment ledger.
2. Trace quoted market prices to independent sources and, for investments stated at fair values as determined by the board of directors, to supporting documentation.[4]
3. Check clerical accuracy of value extensions and footings.
4. Reconcile amounts for assets and liabilities to the general ledger accounts. Where it is not practicable to make entries to the ledgers on a daily basis, a company may utilize work sheets in lieu of daily postings to general ledger accounts, and, if so, these work sheets should be reconciled to the entries subsequently posted to the records. The reasonableness of income and expense accruals, including investment advisory fees and state and local taxes, should be reviewed.
5. Reconcile the number of the company's shares outstanding to the capital stock accounts in the general ledger.
6. Calculate the net asset value per share by dividing total assets less liabilities by the number of shares outstanding.

The extent of the auditor's tests of net asset value computations would depend upon his evaluation of internal accounting control and operating procedures. See "Daily Net Asset Value," page 30.

Investment Advisory (Management) Fee

As discussed in Chapter 1, an investment adviser is usually employed by an investment company and is compensated on a fee basis. This fee is generally the largest expense incurred by the company. It is usually reflected in the daily net asset value calculation at rates established by the investment advisory agreement. Certain of these agreements may provide for a perform-

[4] Accounting Series Release No. 118.

ance fee adjustment that is based upon the company's performance compared to an index specified in the agreement.[5] When determining the amount of a performance fee to be recorded at an interim date, such amount should be recorded based on performance to date. However, interim payments to the adviser, according to Commission policy, should be based on the minimum fee provided in the agreement on the theory that, if performance for the year yields a lesser fee, interim payments of a larger amount may involve loans to the adviser. For performance fees based on a rolling or moving period, reference should be made to the procedures presented in 1940 Act Release No. 7113.

The securities laws of the states in which the investment company's securities are sold generally impose a limitation with respect to certain investment company expenses. For this reason the usual agreement provides that the investment adviser will reimburse the company for certain expenses in excess of a specified percentage of the average value of the company's net assets during the year. In order to determine whether an expense reimbursement should be accrued at an interim date (with the credit normally being shown as a reduction of expense), consideration should be given to estimated expenses for the remainder of the year and it should be assumed, in the absence of strong evidence to the contrary as to expected sales and redemptions, that there will be no change in average net assets.

The independent auditor should review the investment advisory contract in effect during the period under audit to acquaint himself with its provisions (see also "Minutes," page 78). He should then obtain a copy of the schedules used to calculate the fee (and expense reimbursement, if any) during the period, ascertain that the calculations are in agreement with the provisions of the contract, and test the calculations by reference to supporting documentation and for clerical accuracy.

Expenses

The auditor should establish that expenses assumed by the investment company are in accordance with the provisions of

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[5] 1940 Act Release No. 7113.

the investment adivsory contract, prospectus, or other relevant agreement or security laws, such as Section 10(d) of the 1940 Act.

Cash

Time deposits and other funds subject to withdrawal or usage restrictions should be presented separately from other cash accounts.[6]

For cash held by a custodian, the auditor should compare entries in the cash book to bank advices on a test basis and the custodian's statement. He should satisfy himself that the applicable record-keeping requirements of the 1940 Act are being met.[7] The bank balance as of the audit date should be confirmed with the custodian, and cutoff statements should be obtained. Where the investment company maintains cash on hand or in noncustodial accounts[8] and for other funds subject to withdrawal restrictions, cash verification procedures similar to those used in examination of financial statements of other business entities should be applied. (A special report to the board of directors may be required by 1940 Act Release 7164.) In this connection, the auditor should review operating cash considerations to assure himself that cash flows promptly and to the benefit of shareholders.

Minutes

Minutes of meetings of shareholders and directors should be reviewed or copies obtained from the company and conformed to the original. Declarations of dividends, amendments to, and required continuation of, contracts and agreements (e.g., adviser, transfer agent, custodian, underwriter), and other items of significance should be noted in the auditor's work papers as support for transactions reflected in the financial statements. In addition, answers to certain items in Form N-1R must be compared to the minutes by the auditor.

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[6] Rule 6-03-1 of Regulation S-X.
[7] Rules 31a-1, 31a-2, and 31a-3 of the 1940 Act.
[8] Releases 6863, 7107 and 7164 under the 1940 Act.

Transactions With Affiliates

The independent auditor should be familiar with Section 17 of the 1940 Act and related rules which contain certain prohibitions with respect to transactions with affiliates. The auditor should obtain representations from management as to affiliations with certain persons for his use in considering whether additional disclosure is required.

Where there are related entities, such as an underwriter or investment adviser, confirmation of transactions, examination of supporting documents, written representations from the managements of the related entities, and other auditing procedures may be appropriate in the circumstances. Those procedures may be of particular importance where the independent accountant for the investment company is not the auditor for the related entities. In such cases, the audit procedures would be facilitated if the auditor were granted free access to the pertinent accounting records of the related entities and to the auditor for those entities.

In this regard, Accounting Series Release No. 118 states

> Various rules of Regulation S-X require that the financial statements of an investment company state separately investments in, investment income from, gain or loss on sales of securities of, and management or other service fees payable to, (a) controlled companies and (b) other "affiliates." As stated in Rule 6-02-4 of Regulation S-X, the term "affiliate" means an affiliated person as defined in Section 2(a)(3) of the Act, and the term "control" has the meaning given in Section 2(a)(9) of the Act. The term "affiliated person" is defined in Section 2(a)(3) of the Act in such a manner as to encompass such control relationships and also the direct or indirect ownership of five percent or more of the outstanding voting securities of any issuer. An affiliated person as there defined also includes any officer, director, partner, co-partner, or employee or, with respect to an investment company, any investment adviser or member of an advisory board thereof.
>
> In ascertaining the existence of any such affiliations, the independent accountant should consider the facts obtained during the course of an audit and also make inquiries of the company's management; and his working papers should include written representations from the management as evidence of such inquiries. The representations should be in the form of a statement that the company, except to the extent indicated, (i) does not

own any securities either of persons who are directly affiliated, or, to the best information and belief of management, of persons who are indirectly affiliated, (ii) has not received income from or realized gain or loss on sales of investments in or indebtedness of such persons, (iii) has not incurred expenses for management or other service fees payable to such persons, and (iv) has not otherwise engaged in transactions with such persons. Where there is a question as to the existence of an affiliation, a written opinion of legal counsel should be obtained by the company's management, made available to the independent accountant, and a copy included in the working papers. Regulation S-X requires disclosure in the financial statements or notes thereto of details of such investments and transactions.

Registration Fees and Expenses

Generally, expenses of registering, qualifying, and promoting the initial distribution of an investment company's shares are borne by the underwriter or manager. In other instances the investment company itself may assume all or part of these costs and charge them, under normal circumstances, to paid-in capital as shares are sold. Recurring registration fees and expenses of open-end companies are charged to expense as incurred.[9] Closed-end companies charge all registration fees against paid-in capital at the time the shares are sold.

Windfall Profits

Unusual credits to an investment company, such as amounts recoverable arising from the settlement (via judgment or otherwise) of litigation (such as for refund of excess management fees or brokerage commissions) are recognized in the financial statements when the company acquires an enforceable right to them. Unless clearly identifiable with realized or unrealized gains or losses, and depending on the size of the credit in relation to net investment income, the credit should be presented as other income or as a separate item of income or, if sufficiently material, as a credit immediately before the line "net investment income." Due consideration should be given to imputing interest,

[9] Rule 6-03-10(b) of Regulation S-X.

using a reasonable rate, if they are receivable over an extended period and do not provide for such interest.[10] See page 64 for comments on tax ramifications of such unusual credits.

Form N-1R

As discussed in Chapter 1, Form N-1R is the annual report filed with the Securities and Exchange Commission by all registered management investment companies, except those which issue periodic payment plan certificates, which file Form N-30A-2 and small business investment companies which file Form N-5R.

Form N-1R, as amended effective December 1971, must be filed with the Commission within 120 days after the company's year end. The form includes two parts: The first part which contains 39 items and audited financial statements, is public information while the second part, which contains 32 items, may be designated by the company as nonpublic information. Form N-1R also contains an EDP attachment which summarizes certain information reported in Parts I and II. For open-end companies, the auditor is required to furnish his opinion on answers to 22 items or parts thereof, furnish negative assurance on answers to five items or parts thereof and furnish an opinion that the answers to four items or parts thereof are in agreement with the minutes of the board of directors' or shareholders' meetings of the company; his opinion is required on a lesser number of answers in the case of closed-end companies. The auditor is not required to report on any of the information included in the EDP attachment, although information found only in the EDP attachment may be needed to answer questions in Parts I and II, through references to the attachment. The auditor's examination of the financial statements of the company must of course include as part of his examination a review of the accounting system and the system of internal accounting control. Based on this review, the auditor is required to set forth in a report included in Part II of Form N-1R comments upon any conditions which he believes are material weaknesses in the system together with any corrective action taken or proposed.

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[10] APB Opinion No. 21, "Interest on Receivables and Payables."

The auditor's examination should be designed to take cognizance of the statement required in the Form N-1R report: ". . . the scope of the review and tests should be sufficient to provide reasonable assurance that any material weakness existing at the date of (the) examination would be disclosed." Further, as contemplated by Form N-1R, the independent accountant is not permitted, in reporting on internal accounting control under the requirements of Form N-1R, to use the option indicated in paragraph 640.13 of Statement on Auditing Standards No. 1 which states in part "In some cases the auditor may conclude that for certain (material) weaknesses corrective action by management is not practicable in the circumstances and he may decide to exclude such weaknesses from his report." The format of such report to be issued by the auditor on Form N-1R is presented in Chapter 8.

The Commission has published detailed instructions covering the information requested in Form N-1R. The auditor should familiarize himself with the form and instructions and plan to accumulate, on a timely basis, the audit support necessary for him to render his opinion on Form N-1R. Audit support for many of the answers on which the auditor is required to issue an opinion would not normally be accumulated during the course of his examination. These answers include information on underwriting commitments, issuance and redemption of securities, services provided by investment advisers, compensation of principal underwriters, dividends or distributions requiring written statements of shareholders of the registrant, procedures followed upon receipt of orders for purchase, repurchase, or redemption of the registrant's shares, and portfolio transactions not settled by specific settlement dates.

Audit support for entry into or renewal of investment advisory contract, entry into or renewal of the principal underwriting contract, vacancies in board of directors of the registrant, percent of the board elected by security holders, and fidelity bond coverage should be accumulated during the examination when the auditor is reviewing the minutes. Although most of the audit support for the answers to Form N-1R questions will be found in the records maintained by the investment company, the auditor usually will find some information in the company's records maintained by the transfer agent.

Business Combinations

Business combinations of investment companies are essentially buy-outs of security portfolios from unaffiliated companies, regardless of the form of the transaction effecting the combination. Because of the basic nature of such combinations, the pooling criteria established by APB Opinion No. 16, "Business Combinations," do not apply to the combination of unaffiliated investment companies. Accordingly, such mergers and acquisitions are accounted for on a purchase basis under the theory of fair value reporting, in which costs assigned to assets acquired approximate the values of such assets on date of acquisition.

In purchase transactions, the cost of the assets (principally securities) acquired may be measured by the cash disbursed or the fair value of other assets distributed (and, where pertinent, less the present value of liabilities incurred). However, where the acquiring company issues shares of its capital stock, cost is the fair value of the assets received on the date of acquisition. In mergers accounted for as purchases for financial reporting purposes and treated as nontaxable exchanges for tax purposes, the difference between the tax basis of the securities acquired and the ongoing cost based on their value at the date of acquisition could be substantial. As a result of such difference, the gain (loss) reported in the Statement of Operations upon ultimate disposition of those securities would necessarily differ from the amount reported for tax purposes. In such cases, the amount of unrealized appreciation (depreciation) of investments acquired in such nontaxable transactions should be earmarked and the remaining amount of such acquired unrealized appreciation (or potential benefit of unrealized depreciation) should be disclosed in the Statement of Assets and Liabilities or in a note to the financial statements. The value of the shares issued in exchange for the assets acquired in such transactions would be reported in the Statement of Changes in Net Assets under capital share transactions in the year of acquisition.

Distributions to shareholders for the additional (or reduced) taxable security gains, equivalent to the acquired unrealized appreciation (depreciation) arising from sale of such investments should be included in the Statement of Changes in Net

Assets as part of the distribution of realized gains from security transactions, with parenthetic disclosure of additional amounts. Appropriate disclosure of the per-share amounts of such distributions should be made in the five-year per-share table, preferably immediately below the table. In Appendix F an illustration is given of the report presentation of the Statement of Changes in Net Assets for a merger accounted for as a purchase for financial reporting purposes and treated as a nontaxable exchange for tax purposes.

In relatively limited instances, accounting for mergers of investment companies on a continuing entity basis would be appropriate for affiliated entities with similar investment objectives and the same investment adviser that has served in such capacity for each constituent during the two years preceding the merger. In mergers accounted for on a continuing entity basis, the asset values and related costs, unrealized appreciation (depreciation) of investments, undistributed income, and paid-in capital of the acquired company are carried forward in the combined entity. The Statement of Changes in Net Assets is restated to give effect retroactively to such combination. However, per-share amounts of the continuing company are not restated for periods prior to the date of merger in order to maintain the historical base for the value of shares actually outstanding. In certain cases, it may be advisable to present separate per-share figures (based on equivalent exchange rate) of each constituent prior to the date of merger to the extent and for the period such figures may be meaningful to the reader of the financial statements.

Diversification of Assets

A work sheet such as the one in Appendix C may be used by a company to ascertain and document that it has complied with the diversification requirements as set forth in its registration statement.

Although the auditor would not appear to be required to review this determination in order to express his opinion on an investment company's financial statements, he may wish to do so since the company may make representations as to its classification, in notes to the financial statements or elsewhere.

Equity Method

Investment companies are exempt from the application of Accounting Principles Board Opinion No. 18, "The Equity Method of Accounting for Investments in Common Stock" because of their use of value as the method of accounting for portfolio securities. However, investments in other than portfolio securities which meet the criteria of APB Opinion No. 18 and which are made for long-term operating purposes, usually to provide facilities or services to the investment company, should ordinarily be carried on the equity basis.

Chapter 7

Financial Statements

The financial statements of investment companies are directed primarily to the presentation of net asset value, results of operations, and changes in net assets from investment activities and, where applicable, from capital share transactions. In reporting to shareholders, such objectives are well served by presenting a Statement of Assets and Liabilities, with a detailed listing of investments in securities, as of the close of the latest period (or as shown in "Alternative Statement of Net Assets," page 106, a Statement of Net Assets), a Statement of Operations for the latest year, and a Statement of Changes in Net Assets for two years.

The use of a two-year Statement of Changes in Net Assets has been recommended because such an approach, together with supplementary per share data and related information, provides the reader of the financial statements with sufficient financial data by (a) accounting for changes in the Statement of Assets and Liabilities resulting from investment activities and from capital share and other transactions, (b) summarizing amounts in the Statement of Operations for net investment income, realized gains (losses) from security transactions, and changes in unrealized appreciation (depreciation) of investments, and (c) comparing distributions to shareholders with related income. The presentation of such information in a two-year Statement of Changes in Net Assets eliminates the need for complete comparative Statements of Assets and Liabilities and of Operations for each of the years.

The financial statements illustrated in this chapter are for typical open-end management investment companies and may need to be modified to fit the requirements of other types of investment companies. Aspects of reporting on interim financial information are discussed in "Interim Financial Statements," page 96.

In all instances, the management of investment companies and the auditor should be cognizant of the need for reporting in a manner which properly highlights significant information for shareholders and other interested parties. Content and format of reports required by regulatory authorities, e.g., the Securities and Exchange Commission and Small Business Administration, are, of course, governed by the requirements of the applicable form and related rules, regulations, and instructions.

STATEMENT OF ASSETS AND LIABILITIES

The Statement of Assets and Liabilities is considered appropriate for investment companies because it summarizes the net assets in which the investors have an equity interest by listing the assets, deducting liabilities, and arriving at net assets. The format of the Statement affords the reader an opportunity to relate the significance that each asset and liability has to net assets. By the nature of the operations of investment companies, there generally is no segregation of current and long-term assets or liabilities.

Investments in Securities. It is the general practice in the investment company industry to report investments in securities as the first asset because of its relative importance. For purposes of financial statement presentation, the term, "securities," encompasses stocks, bonds, debentures, notes, rights, warrants, certificates of interest or participation in equity or debt instruments, and the like, as well as short-term United States government, bank and commercial paper held for investment purposes. Similar short-term securities representing temporary utilization of cash may be classified as other than portfolio securities.

All investment companies should carry their securities in financial statements at value, with cost shown parenthetically, as discussed more fully in Chapter 2. The Statement or an accompanying portfolio of investments should list the securities, other than short-term, at the close of the period by major classifications[1] (such as (1) by investments in common stocks, preferred stocks, convertible securities, United States government and agency obligations, and other appropriate securities, (2) by equity securities and debt securities, (3) by securities held within industry groups, or (4) by a combination of these classifications). Venture capital companies and SBICs may prefer to list all securities of an individual issuer in one place.

The portfolio should list each security issue with the number of shares or principal amount of the securities and value[2] with cost shown parenthetically for each separate category, such as common stocks, preferred stocks, etc. Short-term investments should be summarized by issuer and by ranges of maturity dates. Investments in restricted securities[3] and in affiliated companies[4] require special disclosure in the portfolio of investments and specific information in notes to the financial statements concerning method of valuation. Short-term securities held as temporary utilization of cash should be separately classified in the Statement of Assets and Liabilities.

Cash and Cash Items. Cash on hand and demand deposits are included under the general caption of "Cash." Time deposits and other funds subject to withdrawal restrictions usually require separate disclosure in the Statement or notes thereto.

Receivables. Receivables are usually listed separately for each of the following categories:

(a) Dividends and interest receivable on investments in securities.

(b) Receivable for investment securities sold.

(c) Receivable for capital stock sold.

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[1] For registered companies see Rule 6-03 of Regulation S-X.

[2] In certain circumstances securities, which in the aggregate do not exceed five percent of the value of total investments in securities, may be listed in one amount entitled "Miscellaneous Securities." See Rule 12-19 of Regulation S-X.

[3] For specific requirements concerning disclosures of information relating to restricted securities, see Accounting Series Releases Nos. 113 and 116.

[4] See separate section in Accounting Series Release No. 118 on affiliated companies.

(d) Notes receivable, other than investment securities.

(e) Other accounts receivable, such as from investment advisers for expense reimbursements. (See "Investment Advisory (Management) Fee," page 76.)

Other Assets. Normally included under this caption are deferred organization expense, prepaid taxes, furniture and fixtures, and similar prepaid and deferred items. Separate amounts are not usually reported unless significant, generally five percent or more of total assets.

Accounts Payable. Accounts payable are usually listed separately for each of the following categories:

(a) Payable for investment securities purchased.

(b) Payable for capital stock reacquired.

(c) Other accounts payable.

Accrued Liabilities. Included under this caption are accrued taxes, management fees, interest, compensation, and other expenses incurred in the normal course of operations. Material accruals should be set out separately as stated in Regulation S-X, Rule 6-03-14.

Notes Payable and Other Debt. Separate reporting is made of notes payable to banks and to others, bonds, mortgage debt, and other funded debt. Debt due to affiliates and directors requires separate disclosure within the Statement.

Dividends Payable. Dividends payable subsequent to the date of the Statement are reported separately, with information on the face of the Statement or in notes thereto as to the payable date and amount for each outstanding share of capital stock.

Other Liabilities. Items included under this caption are unamortized premiums on options written, deferred income, and deferred state and local taxes on unrealized appreciation (which should be recorded where material). Where a company does not qualify under Subchapter M of the Internal Revenue Code, provision for deferred federal income taxes on unrealized appreciation may also be required. Each significant item, generally representing 5 percent or more of total assets, should be reported separately.

Net Assets. Shareholders' equity includes not only amounts contributed by shareholders, but also undistributed income and unrealized appreciation of investments; while it is not necessary to present the separate accounts in the Statement of Assets and Liabilities, certain information should be disclosed in the Statement or notes thereto as indicated:

(a) Paid-in capital—consisting of the net of proceeds received on the sale of capital shares less the cost of reacquired shares, adjusted, where such accounting practice is followed, for amounts apportioned to the equalization account. The number of capital shares authorized and the number outstanding should be disclosed.

(b) Undistributed net investment income—representing, on a cumulative basis, net investment income or loss and, where such accounting practice is followed, amounts apportioned to the equalization account, net of dividends paid. The amounts at the beginning and end of the period are normally disclosed in the Statement of Changes in Net Assets.

(c) Undistributed net realized gain from security transactions—encompassing, on a cumulative basis, all gains and losses realized from security transactions, net of allocated taxes, if any, on such gains, and net of distributions to shareholders. If amounts greater than the net gains reported for financial statement purposes are distributed (e.g., where gains for tax purposes exceed those reported for financial statement purposes), such excess distribution is deducted from paid-in capital; the cumulative amount of such excess distributions should be disclosed.

(d) Unrealized appreciation (depreciation) of investments—representing the difference between the cost and the value of the securities owned at the close of the period. If provided for, deferred federal, state, and local taxes on unrealized appreciation would be charged against this caption and disclosed.

Where the Statement does not present these accounts separately, the single line "Net Assets" would be shown.

Net Asset Value Per Share. The value attributed to each share of capital stock outstanding at the close of the period.

STATEMENT OF OPERATIONS

The Statement of Operations is designed to present the results of all investment activities of the company by reporting separately investment income or loss and the combination of realized gains or losses from security transactions and change in unrealized appreciation or depreciation of investments for the current period. This format permits the reader to readily observe the contribution each element of investment activity has made to the overall operations of the company.

Investment Income

Dividend Income. Dividend income is recorded as of the ex-dividend date. Noncash dividends, dividends in arrears on preferred stock, dividends other than from retained earnings, and dividends from affiliates and controlled companies usually require separate reporting and disclosure within the Statement or in notes thereto.

Interest Income. Interest income is generally accrued on all debt securities. As discussed in Chapter 3, special treatment is given to the reporting of interest received on bonds traded flat or in default when acquired and to the accounting for interest on delinquent debt securities. Disclosure of interest earned on securities of affiliates and controlled companies is usually required.

Other Income. Income from rents and miscellaneous sources, as well as unusual dividend and interest income, is included in other income. All items usually are combined in one amount except for those accounting for more than 5 percent of total investment income.

Expenses. Separate reporting of each expense accounting for 5 percent of total expenses is necessary. Expenses commonly requiring such reporting are as follows:

(a) Investment advisory (management) fee (or compensation).

(b) Shareholder servicing costs, including transfer agent and dividend disbursing agent fees and expenses.

(c) Custodian fees.

(d) Reports to shareholders.

(e) Taxes, including federal, state, and local.

(f) Interest.

(g) Legal fees.

(h) Auditing fees.

(i) Directors' fees.

(j) Registration fees and expenses (see "Registration Fees and Expenses," page 80).

Amounts paid to affiliates should be disclosed and the basis on which management and advisory fees (as well as other amounts paid to affiliates) are determined should be described in a note to the financial statements. Where state laws or the advisory agreement provide that the adviser will reimburse the company for expenses over a specified percentage of average net assets, disclosure of this provision and the amount, if any, should be set forth.

Realized and Unrealized Gain (Loss) on Investments

Realized Gain (Loss) From Security Transactions.

1. Proceeds from sales of securities—The proceeds from sales of all securities considered to be investment securities, other than short-term securities, for financial statement purposes (see "Investments in Securities," page 87) should be reported in the aggregate in the Statement of Operations. The proceeds reported should be net of brokerage commissions and other expenses, such as transfer taxes, directly related to security sales. When proceeds of a sale are not in cash, valuation may provide unusual uncertainty which must be dealt

with on a case-by-case basis. Disclosure of the breakdown of the proceeds by (a) securities other than United States government and agency obligations, (b) United States government and agency obligations, and (c) affiliates, if any, may be informative in certain cases and may be made as supplementary information[5] or the pertinent information may be included in a note to the financial statements.

2. Cost of securities sold—The aggregate cost of securities sold should be reported in the Statement. The basis used in determining the cost of securities sold should be disclosed in the Statement or in a note thereto, and, if a basis other than the average cost method is used, the difference (if material) in gain (loss) between that determined on the average cost method and that on the method actually used should be disclosed, if practicable.
3. Provision for income taxes—The provision for federal, state, and local taxes should be reported separately in the Statement, if material.

Change in Unrealized Appreciation (Depreciation) of Investments. The amounts of unrealized appreciation at the beginning of the period and at the end of the period and the increase or decrease in such amounts should be shown in the Statement.

If state and local taxes are expected to be paid in future periods upon realization of the present unrealized appreciation of investments and such taxes are considered significant in relation to net assets, or where a company does not qualify as a regulated investment company under the Internal Revenue Code (unless it does not expect to pay federal taxes in future periods as appreciation is realized), provision for such deferred taxes should be separately reported and deducted from the change in the unrealized appreciation for the period.

STATEMENT OF CHANGES IN NET ASSETS

The Statement of Changes in Net Assets summarizes separately the changes resulting from investment activities and those from capital share transactions, in comparative form. Such format

[5] Section 30(d)(6) of the 1940 Act.

presents an overview of the results of operations of each investment activity and related distributions to shareholders and of the capital share transactions during the periods.

Increase (Decrease) in Undistributed Net Investment Income. The change in the undistributed net investment income is accounted for by reporting separately (a) the net investment income shown in the Statement of Operations, (b) in those cases where equalization accounting is followed, the undistributed investment income included in the price of capital shares issued and reacquired, and (c) the dividends to shareholders. The per-share amount of dividends during the current year should be disclosed.

Increase (Decrease) in Undistributed Net Realized Gains (Losses) from Security Transactions. The change in undistributed net realized gains (losses) from security transactions is reported by stating the net realized gain (loss) shown in the Statement of Operations and the distributions of realized gain to shareholders. In many cases, investment companies follow the practice of distributing in the succeeding year the security gains realized in the preceding year; information concerning the amount and per-share rate of the distribution to be made in the succeeding year should be disclosed, if known, in a note to the Statement, as well as the per-share amount of distribution during the current year.

Increase (Decrease) in Unrealized Appreciation (Depreciation) of Investments. The change in unrealized appreciation (depreciation) of investments is the same amount as reported in the Statement of Operations.

Increase (Decrease) in Net Assets Derived From Investment Activities. The net increase (decrease) from investment activities represents the net change in undistributed investment income, in undistributed realized gains from security transactions, and in unrealized appreciation (depreciation) of investments.

Capital Share Transactions. Capital share transactions (exclusive of amounts allocated to investment income if equalization concept is used) may be reported in the following manner:

(a) Proceeds from sales of capital shares.
(b) Net asset value of shares issued to shareholders who reinvest income dividends and capital gain distributions in the company, either separately or combined.
(c) Cost of capital shares reacquired.
(d) Net increase (decrease) arising from capital share transactions.

The number of capital shares sold, issued through reinvestments and reacquired and the net increase or decrease in outstanding shares for the period should be shown either in the Statement or in a note to the financial statements.

Other Items. Any other charges or credits to surplus accounts not reported above should be shown under this caption with appropriate description.

SUPPLEMENTARY INFORMATION

Per-Share Data. Per-share data accounting for the changes in net asset value are supplementary information (although they may be included in notes to financial statements) and should be reported for at least a five-year period. The per-share amounts should be computed on the basis of a share outstanding throughout the period.[6] The following categories should be considered for reporting such per-share data:

(a) Investment income.
(b) Expenses (income taxes and interest on borrowed funds should be reported separately, if material).
(c) Net investment income.
(d) Dividends from net investment income.
(e) Net realized gain (loss) and change in unrealized appreciation (depreciation) of securities (combined).

[6] The method of computation of per-share amounts is set forth in the instructions to Item 1.05, Form N-1R.

(f) Distribution from net realized gain from security transactions.

(g) Net increase (decrease) in net asset value.

(h) Net asset value at the beginning and at the end of the period.

Other information which might be reported for the same five-year period includes:

(i) Ratio of expenses to average net assets for each period.

(j) Ratio of net investment income to average net assets for each period.

(k) Portfolio turnover for each period.

(l) Number of shares outstanding at end of each period (generally in thousands).

Significant Portfolio Changes. Investment companies often give a tabulation of the principal purchases and sales of portfolio securities which have occurred during the period since the prior report. These tabulations often show the name of the security, the number of shares purchased or sold, and the remaining portfolio holdings in each such security. Other companies report securities which are new to the portfolio and those which have been eliminated. While such tabulations of portfolio activity are not at this time required, their presentation in reports to shareholders is recommended in the production of meaningful information for the investor as discussed on page 21.

INTERIM FINANCIAL STATEMENTS

While net asset value per share is normally reported daily by open-end investment companies and weekly by many closed-end investment companies, interim financial data are usually (required for registered companies) issued semiannually (and often quarterly) by most investment companies to provide current information on net assets, results of operations, and changes in net assets. (See "Stockholder Reporting," page 12.) Some companies issue complete financial statements while others have issued only condensed and selected information to highlight significant financial or operating results.

Interim financial statements or selected financial information should be based upon generally accepted accounting principles and practices which conform to those used in the preparation of the annual financial statements. Interim statements that purport to present net assets, results of operations, and changes in net assets should include the same disclosures as those presented in annual reports with the Statement of Changes in Net Assets showing the latest interim period and the last fiscal year.[7] Supplementary information should show the latest interim period and the five preceding fiscal years.

Nevertheless, reporting of condensed financial information at quarterly dates in less detail than that provided at semiannual or fiscal year end dates may be appropriate. In such cases the following data would seem to be most useful to the investor:

1. Schedule of securities owned, with the number of shares or principal amount and value shown for each investment; other assets less liabilities; net assets; and per-share net asset value at the close of the period.
2. Summarization of net investment income (loss) and combined realized gain (loss) from security transactions and change in unrealized appreciation (depreciation) of investments on a fiscal year-to-date basis.
3. Selected per-share data and operating information considered by management to be the most meaningful to the investor.

Unaudited interim financial data should be marked "unaudited." Data summarized in condensed form also should be so labeled. Where the independent accountant is named or identified in unaudited interim reports he should require that a disclaimer of opinion be included or reference to him be deleted.[8]

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[7] Rule 30d-1(d)(3) of the 1940 Act requires presentation of certain per-share figures for the current period and for the three complete fiscal years preceding.

[8] Statement on Auditing Standards No. 1, section 516. (New York: AICPA, 1973.)

ILLUSTRATIVE FINANCIAL STATEMENTS

The figures used in the accompanying financial statements are illustrative only and are not intended to indicate any relationship among accounts. The sample financial statements have been prepared to show where and how various items might be presented, assuming they are material in the particular statement. In the usual situation, several items may not be present and some of those that are might well be combined and presented as a single item.

SAMPLE MANAGEMENT INVESTMENT COMPANY
Statement of Assets and Liabilities
December 31, 19X2

Assets:	
Investments in securities, at value (identified cost $15,776,000) (Note 1-A)	$17,153,000
(Note to reader: In addition to a portfolio of investments, there may be presented herein a breakdown of investments by major classifications as considered appropriate for the company's holdings and investment objectives)	
Temporary investments in short-term securities (at cost which approximates market)	50,000
Cash (including time deposits, $50,000)	199,000
Receivables:	
Dividends and interest	46,000
Investment securities sold	24,000
Capital stock sold	54,000
Other assets	26,000
Total Assets	17,552,000
Liabilities:	
Payables:	
Investment securities purchased	52,000
Capital stock reacquired	8,000
Other	4,000
Accrued taxes (Note 1-B)	8,000
Dividend payable January 3, 19X3 ($.04 a share)	168,000
Total Liabilities	240,000
Net Assets (Equivalent to $4.11 per share based on 4,216,000 shares of capital stock outstanding) (Note 4)	$17,312,000

See Notes to Financial Statements

SAMPLE MANAGEMENT INVESTMENT COMPANY
Portfolio of Investments in Securities
December 31, 19X2

Security	Number of Shares or Principal Amount	Value
Common Stock—54.07%		
(Note to reader: Securities may be arranged in industry groupings [showing percentage of total portfolio invested in each grouping] which the company feels will best permit the reader to relate the security holdings to its investment objectives.)		
Consumers' Durable Goods—12.39%:		
Allied Manufacturing Corporation	25,000	$ 620,000
Etc.		
Total		2,125,000
Consumers' Nondurable Goods--4.37%:		
Amalgamated Buggy Whips, Inc. (Note 2)	10,000	280,000
Etc.		
Total		750,000
Service Industries—5.39%:		
Related Company, Inc.	10,000	465,000
Etc.		
Total		925,000
Etc.		
Total common stocks (cost $9,276,000)		9,275,000
Convertible Securities—31.48%		
American Retailing Inc. 5½% convertible debentures due 19XX (Note 2)	$500,000	525,000
Etc.		
Total convertible securities (cost $4,000,000)		5,400,000
U. S. Government Obligations—8.60%		
U. S. Treasury 6% notes due 19XX	$500,000	490,000
Etc.		
Total U. S. government obligations (cost $1,500,000)		1,475,000
Short-Term Notes—5.85%		
Commercial Paper, Inc., due February 3, 19X3	$500,000	505,000
Etc.		
Total short-term notes (cost $1,000,000)		1,003,000
Total (cost $15,776,000) (Note 1-A)		$17,153,000

See Notes to Financial Statements

SAMPLE MANAGEMENT INVESTMENT COMPANY
Statement of Operations

For the year ended December 31, 19X2

Investment Income:		
Income:		
Dividends	$ 592,000	
Interest	109,000	
Total income		$ 701,000
Expenses:		
Investment advisory fee (Note 6)	40,000	
Shareholder servicing costs	6,000	
Custodian fees	3,000	
State and local taxes, excluding taxes allocated to realized gains	3,000	
Legal and auditing fees (Note 6)	6,000	
Reports to shareholders	2,000	
Other	4,000	
Total expenses		64,000
Net investment income		$ 637,000
Realized and Unrealized Gain (Loss) on Investments (Note 5):		
Realized gain from security transactions (excluding short-term securities):		
Proceeds from sales	$2,891,000	
Cost of securities sold	2,002,000	
	889,000	
Provision for state and local taxes	12,000	
Net realized gain		$ 877,000
Unrealized appreciation of investments:		
Beginning of period	3,988,000	
End of period	1,377,000	
Decrease in unrealized appreciation		(2,611,000)
Net realized and unrealized gain (loss) on investments		($1,734,000)

See Notes to Financial Statements

SAMPLE MANAGEMENT INVESTMENT COMPANY
Statement of Changes in Net Assets

For the years ended December 31, 19X2 and 19X1

	19X2	19X1
From Investment Activities:		
Net investment income	$ 637,000	$ 575,000
Undistributed investment income included in price of shares sold and repurchased	9,000	6,000
	646,000	581,000
Dividends to shareholders	645,000	568,000
Increase (decrease) in undistributed net investment income	1,000	13,000
Net realized gain from security transactions	877,000	1,239,000
Distributions to shareholders (Note 3)	1,239,000	1,060,000
Increase (decrease) in undistributed net realized gains	(362,000)	179,000
Increase (decrease) in unrealized appreciation of investments	(2,611,000)	1,229,000
Increase (decrease) in net assets derived from investment activities	(2,972,000)	1,421,000
From Capital Share Transactions (exclusive of amounts allocated to investment income) (Note 4):		
Net proceeds from sale of shares	1,948,000	1,440,000
Net asset value of shares issued to shareholders in reinvestment of net investment income and realized gain from security transactions	1,000,000	845,000
	2,948,000	2,285,000
Cost of shares repurchased	456,000	530,000
Increase (decrease) in net assets derived from capital share transactions	2,492,000	1,755,000
Net increase (decrease) in net assets	(480,000)	3,176,000
Net Assets:		
Beginning of period	17,792,000	14,616,000
End of period (including undistributed net investment income of $36,000 and $35,000 respectively)	$17,312,000	$17,792,000

See Notes to Financial Statements

SAMPLE MANAGEMENT INVESTMENT COMPANY
Notes to Financial Statements
December 31, 19X2 and 19X1

(Note to reader: The following notes to financial statements are illustrative only. In some situations, the information contained therein may be better presented within the financial statements; in other situations, information not required by regulation may not be of sufficient materiality to warrant disclosure.)

1. Significant Accounting Policies

The Company is registered under the Investment Company Act of 1940, as amended, as a diversified, open-end management company. The following is a summary of significant accounting policies consistently followed by the Company in the preparation of its financial statements. The policies are in conformity with generally accepted accounting principles.

(A) *Security Valuation.* Investments in securities traded on a national securities exchange are valued at the last reported sales price on the last business day of the year; securities traded in the over-the-counter market and listed securities for which no sale was reported on that date are valued at the mean between the last reported bid and asked prices; securities representing capital stock of other open-end investment companies are valued at net asset value as reported by such companies; short-term notes are stated at amortized cost which approximates market value; and investments in affiliated companies and restricted securities are valued at fair value as determined by the board of directors.

(B) *Federal Income Taxes.* It is the Company's policy to comply with the requirements of the Internal Revenue Code applicable to regulated investment companies and to distribute all of its taxable income to its shareholders. Therefore, no federal income tax provision is required.

(C) *Equalization.* The Company follows the accounting practice known as equalization by which a portion of the proceeds from sales and costs of repurchases of capital shares equivalent, on a per-share basis, to the amount of distributable investment income on the date of the transaction is credited or charged to undistributed income. As a result, undistributed investment income per share is unaffected by sales or redemptions of fund shares.

(D) *Other.* As is common in the industry, security transactions are accounted for on the date the securities are purchased or sold. Dividend income and distribution to shareholders are recorded on the ex-dividend date.

2. Restricted Securities

Investment in 10,000 shares of Amalgamated Buggy Whips, Inc. common stock is restricted as to sale and has been valued by the board of directors at a price which represents 75 percent of cost after giving due consideration to certain pertinent factors, including the results of operations of Amalgamated since the date of purchase in 19X1 and the sales price of recent private placements in its common stock. There is no quoted market in Amalgamated shares.

Investment in $500,000 of American Retailing, Inc. 5½ percent convertible debentures due 19XX is restricted as to resale and has been valued by the board of directors by discounting the quoted market price of the unrestricted common stock into which the debentures are convertible; at December 31, 19X2, this discount was 10 percent. This security was acquired in March, 19X2; its cost was 15 percent less than the market price of an equivalent amount of unrestricted common stock at the date the purchase price was agreed to and 12 percent less on the date the Company first acquired an enforceable right to acquire the debentures.

> (Note to reader: Generally, information as to the "handshake" and "enforceable right" dates may be omitted one year after acquisition of the securities.)

Where future dispositions of the above restricted securities acquired in private placements require registration under the Securities Act of 1933, the Company has the right to include its shares in such registration without cost to the Company.

> (Note to reader: Where a number of restricted security investments are held, a general statement as to the valuation methods may be given rather than individually as in the above paragraphs.)

3. Distributions

Realized gains from security transactions are distributed to shareholders in the succeeding year. A distribution of $.21 a share, aggregating $886,000, was declared on January 10, 19X3, from net realized gain from security transactions earned during 19X2. The distribution was paid on January 20, 19X3, to each shareholder of record on January 10, 19X3. Accumulated undistributed net realized gains at December 31, 19X2, amounted to $877,000.

4. Capital Stock

At December 31, 19X2, there were 5,000,000 shares of $.50 par value capital stock authorized, and capital paid in aggregated $15,022,000. Transactions in capital stock were as follows:

	19X2	19X1
Shares sold	452,000	329,000
Shares issued to shareholders in reinvestment of net investment income and realized gain from security transactions	222,000	207,000
	674,000	536,000
Shares reacquired	104,000	121,000
Net increase	570,000	415,000

5. Purchases and Sales of Securities

Purchases and sales of securities other than United States government obligations and short-term notes aggregated $4,066,000 and $1,964,000, respectively. Sales of United States government obligations aggregated $927,000.

For federal income tax purposes the identified cost of investments owned at December 31, 19X2, was $14,937,000. Had the average cost basis been used for financial statement purposes, realized gains would have been increased and unrealized appreciation decreased by $10,000.

6. Investment Advisory Fee and Other Transactions With Affiliates

Investment Adviser received fees of $40,000 in 19X2 for investment management and advisory services. The fee is based on average daily net assets at the annual rate of one-half of one percent on the first $20 million and one-quarter of one percent on the excess over $20 million. Investment Adviser also received $10,000 in 19X2 from commissions earned on sales of Sample Management Investment Company capital stock and $5,000 from brokerage fees on its purchases and sales of portfolio securities. During 19X2 legal fees of $1,000 were paid to Brown and Smith, counsel for the Company. John F. Smith, a partner of that firm, is a director of the Company.

Supplementary Information

Selected data for each share of capital stock outstanding throughout each year:

	Year ended December 31,				
	19X2	19X1	19X0	19X9	19X8
Investment income	$.17	$.17	$.16	$.16	$.15
Expenses*	.01	.01	.01	.01	.01
Net investment income	.16	.16	.15	.15	.14
Dividends from net investment income	(.16)	(.16)	(.15)	(.15)	(.14)
Net realized gain and increase (decrease) in unrealized appreciation	(.43)	.67	.62	(.42)	.31
Distribution from net realized gain from security transactions	(.34)	(.33)	(.24)	(.23)	(.20)
Net increase (decrease) in net asset value	(.77)	.34	.38	(.65)	.11
Net asset value:					
Beginning of period	4.88	4.54	4.16	4.81	4.70
End of period	$4.11	$4.88	$4.54	$4.16	$4.81
Ratio of expenses to average net assets	.40%	.39%	.39%	.37%	.36%
Ratio of net investment income to average net assets	3.98%	3.83%	3.68%	3.53%	3.38%
Portfolio turnover	15%	14%	16%	13%	15%
Number of shares outstanding at end of period (in thousands)	4,216	3,646	3,506	3,166	2,996

See Notes to Financial Statements

Note to reader: The above supplementary information may also be presented as a note to the financial statements; in either case, it is recommended that at least the current year be covered by the report of the independent accountant. In such cases, the information for the other years should be clearly marked "unaudited."

* If significant amounts of interest or taxes are included in expenses for any given year, separate disclosure of per-share amounts should be given in the table.

ALTERNATIVE STATEMENT OF NET ASSETS

An acceptable alternative method of presenting the statement of assets and liabilities and portfolio of investments is to present a Statement of Net Assets, as is illustrated below. In using this presentation, the investment company should be aware of the need for reporting, in the statement or notes thereto, details of "other assets, less liabilities" in a manner which properly highlights significant information for shareholders and other interested parties.

SAMPLE MANAGEMENT INVESTMENT COMPANY
Statement of Net Assets

December 31, 19X2

	Number of Shares or Principal Amount	Value
Investments in Securities—99.08% (Note 1-A):		
Common Stocks—53.58%		
Consumers' Durable Goods—12.27%:		
Allied Manufacturing Corporation	25,000	$ 620,000
Etc.		
Total		2,125,000
Consumers' Nondurable Goods—4.33%:		
Amalgamated Buggy Whips, Inc. (Note 2)	10,000	280,000
Etc.		
Total		750,000
Service Industries—5.34%:		
Related Company Inc.	10,000	465,000
Etc.		
Total		925,000
Etc.		
Total common stocks (cost $9,276,000)		9,275,000

SAMPLE MANAGEMENT INVESTMENT COMPANY
Statement of Net Assets

December 31, 19X2
(continued)

	Number of Shares or Principal Amount	Value
Convertible Securities—31.19%:		
American Retailing Inc., 5½% debentures due 19XX (Note 2)	$500,000	$ 525,000
Etc.		
Total convertible securities (cost $4,000,000)		5,400,000
U. S. Government Obligations—8.52%:		
U. S. Treasury 6% notes due 19XX	$500,000	490,000
Etc.		
Total U. S. Government obligations (cost $1,500,000)		1,475,000
Short-Term Notes—5.79%:		
Commercial Paper, Inc., due January-February 19X3	$500,000	505,000
Etc.		
Total short-term notes (cost $1,000,000)		1,003,000
Total investments in securities (cost $15,776,000)		17,153,000
Other Assets, Less Liabilities—0.92%		159,000
Net Assets (Equivalent to $4.11 per share based on 4,216,000 shares of capital stock outstanding) (Note 4)		$17,312,000

See Notes to Financial Statements

(Note to Reader: Securities may be arranged in industry groupings which the company feels will best permit the reader to relate the security holdings to its investment objectives.)

Chapter 8

Independent Accountant's Reports

Distinctive wording has been developed for the auditor's report on the examination of financial statements of investment companies to specifically cover, because of the high relative importance of investments in securities, the manner in which the existence of securities has been substantiated (whether by confirmation or physical examination) and, in certain instances (see page 35), where a material portion of the securities are valued in "good faith," the extent to which the procedures and underlying documentation support the directors' valuations.[1] It is also customary (required for registered investment companies[2]) to address the auditor's report to the shareholders and to the board of directors of the company.

The following reports are intended to be illustrative of pertinent items discussed in preceding chapters. They do not purport to cover all of the different situations that may arise in practice. It is essential that appropriate modification be made to meet the requirements of particular circumstances.

[1] Accounting Series Release No. 118.
[2] Section 32 (a) of the 1940 Act.

Reports on Financial Statements

First Example. The following form is appropriate for expressing an unqualified opinion on the financial statements when the auditor is able to satisfy himself concerning the values assigned to investments.

To the Shareholders and Board of Directors
of Sample Management Investment Company:

We have examined the statement of assets and liabilities of Sample Management Investment Company including the portfolio of investments as of December 31, 19X2, and the related statement of operations for the year then ended, the statement of changes in net assets for the two years then ended, and supplementary information for the five years then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances, including confirmation of securities owned at December 31, 19X2, by correspondence with the custodian and brokers.

In our opinion, the aforementioned financial statements present fairly the net assets of Sample Management Investment Company at December 31, 19X2, the results of its operations for the year then ended and the changes in its net assets for the two years then ended, in conformity with generally accepted accounting principles applied on a consistent basis. Also, in our opinion, the supplementary information for the five years ended December 31, 19X2, is fairly stated in all respects material in relation to the financial statements taken as a whole.

Independent Auditor

Anytown, USA
January 21, 19X3

> Note to reader: It is recommended that at least the most recent year of supplementary information be covered by the auditor's opinion; prior years may be included on an unaudited basis, especially if prior years were examined by another auditor. If there is no payable for securities purchased, reference to "and brokers" at the end of the scope paragraph would not normally be required. Also, if securities were "verified by actual examination" the opinion would be appropriately modified. See also second example for appropriate wording for situations where all confirmations from brokers were not received.

Second Example. As more fully discussed on page 48, another form may be used for expressing an opinion on the financial statements in which there is a material portion of the securities valued "in good faith" by the board of directors and for which the auditor has examined the documentation supporting such securities valuation and found nothing to indicate that the valuation principles are not acceptable or have not been consistently applied or that the valuation is not reasonably supported by competent evidential matter.

To the Shareholders and Board of Directors
of Sample Management Investment Company:

We have examined the statement of assets and liabilities of Sample Management Investment Company including the portfolio of investments as of December 31, 19X2, and the related statement of operations for the year then ended, the statement of changes in net assets for the two years then ended, and supplementary information for the five years then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances. Securities owned at December 31, 19X2, except securities purchased but not received, were confirmed to us by the custodian (or "counted" if such is the audit procedure). As to securities purchased but not received, we requested confirmation from brokers, and, where replies were not received, we carried out other appropriate auditing procedures.

As discussed more fully in Note 2 to the financial statements, securities amounting to $________ (____% of the net assets) have been valued at fair value as determined by the board of directors. We have reviewed the procedures applied by the directors in valuing such securities and have inspected underlying documentation; while in the circumstances the procedures appear to be reasonable and the documentation appropriate, determination of fair values involves subjective judgment which is not susceptible to substantiation by auditing procedures.

In our opinion, subject to the possible effect on the financial statements of the valuation of securities determined by the board of directors as described in the preceding paragraph, the aforementioned financial statements present fairly the net assets of Sample Management Investment Company at December 31, 19X2, and the results of its operations, changes in its net assets, and supplementary information for the respective years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

Independent Auditor

Anytown, USA
January 21, 19X3

Third Example. The requirements of the Small Business Administration as to financial statements of small business investment companies (SBICs) call for reporting security investments at the lower of cost or value, while generally accepted accounting principles provide that security investments by investment companies be carried at value. The independent auditor must follow the requirement of paragraph 544.02 of AICPA Statement on Auditing Standards No. 1, which includes the following statement which is applicable when financial statements of SBICs are presented in conformity with regulatory requirements.

> . . . material variances from generally accepted accounting principles, and their effects, should be dealt with in the independent auditor's report in the same manner followed for companies which are not regulated. Ordinarily, this will require either a qualified or an adverse opinion on such statements.

An independent auditor's qualified report which might be used in these instances is illustrated below:

> We have examined the. . . . Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances, including confirmation of securities owned at March 31, 19X2, by correspondence with the custodian.
>
> The Company presents its financial statements in conformity with accounting practices prescribed by the Small Business Administration, which provide for presentation of security investments at the lower of cost or value. Generally accepted accounting principles provide for reporting of investments by investment companies at value. Had value been used, (make reference to major items in the financial statements which would be affected) would have been increased (decreased) by $______, as more fully described in Note __.
>
> Also, as more fully discussed in Note __ to the financial statements, securities which at value amount to $______ (__% of the shareholders' equity, with investments stated at value) have been valued at fair value as determined by the board of directors. We have reviewed the procedures applied by the directors in valuing such securities and have inspected underlying documentation; while in the circumstances, the procedures appear to be reasonable and the documentation appropriate, determination of fair value involves subjective judgment which is not susceptible to substantiation by auditing procedures.

In our opinion, except for the effects on the accompanying financial statements of the variance from generally accepted accounting principles referred to in the second preceding paragraph, and subject to the possible effect on such statements of the valuation of securities determined by the board of directors as described in the immediately preceding paragraph, the accompanying financial statements present fairly. . . .

Independent Auditor

Anytown, USA
June 15, 19X2

Report on Examination of Securities Pursuant to Rules Under the 1940 Act

This form of report is used for each examination of securities mandated under Rules 17f-1 and 2 of the 1940 Act and as described in Accounting Series Release No. 27.

To the Board of Directors of
Sample Management Investment Company:

We have made an examination of the investment accounts shown by the books and records of Sample Management Investment Company for the period from the date of our last similar examination on April 28, 19X2, to August 17, 19X2. Our examination was made in accordance with generally accepted auditing standards and without prior notice to the Company.

Securities owned as of the close of business on August 17, 19X2 shown by the books and records examined by us which were accounted for by count and inspection thereof were located in the vault of (*name and address*), except for securities purchased but not received, pledged, and out for transfer on that date, as to which we obtained confirmation from the brokers, pledgees, and transfer agents, respectively.

Independent Auditor

Anytown, USA
September 23, 19X2

Note to reader: Where the examination is not on a surprise basis, the phrase "and without prior notice to the Company" would be deleted.

Report Covering Specific Items and Review of Accounting System and System of Internal Accounting Control Required in Annual Report (Form N-1R) Filed With the Securities and Exchange Commission

As discussed in Chapter 6, the auditor is required to express an opinion on numerous answers by the investment companies in Parts I and II of the Annual Report (Form N-1R) filed with the Commission, on his review of the accounting system and the system of internal accounting control, and on any conditions which he believed to be material weaknesses in the system together with any corrective action taken or proposed. The format of such report is discussed in the Form itself and, in current practice, should read as follows:

To the Board of Directors of
Sample Management Investment Company:

We have examined the financial statements of Sample Management Investment Company for the year ended December 31, 19X2, as listed in the answer to Item 1.39 in Form N-1R and have issued our opinion thereon dated January 21, 19X3. As a part of our examination, we reviewed and tested the company's system of internal accounting control to the extent we considered necessary to evaluate the system as required by generally accepted auditing standards and the requirements of Form N-1R under the Investment Company Act of 1940. The requirements of Form N-1R contemplate that the scope of the review and tests should be sufficient to provide reasonable assurance that any material weakness existing at the date of our examination would be disclosed. Under these standards and those requirements the purposes of such evaluation are to establish a basis for reliance thereon in determining the nature, timing, and extent of other auditing procedures that are necessary for expressing an opinion on the financial statements and to provide a basis for reporting material weaknesses in internal accounting control.

The objective of internal accounting control is to provide reasonable, but not absolute, assurance as to the safeguarding of assets against loss from unauthorized use or disposition, and the reliability of financial records for preparing financial statements and maintaining accountability for assets. The concept of reasonable assurance recognizes that the cost of a system of internal accounting control should not exceed the benefits derived and also recognizes that the evaluation of these factors necessarily requires estimates and judgments by management. However, for the purposes of this report required by Form N-1R, the cost-benefit relationship has been disregarded in determining material weaknesses to be reported.*

There are inherent limitations that should be recognized in considering the potential effectiveness of any system of internal accounting control. In the performance of most control procedures, errors can result from misunderstanding of instructions, mistakes of judgment, carelessness, or other personal factors. Control procedures whose effectiveness depends upon segregation of duties can be circumvented by collusion. Similarly, control procedures can be circumvented intentionally by management with respect either to the execution and recording of transactions or with respect to the estimates and judgments required in the preparation of financial statements. Further, projection of any evaluation of internal accounting control to future periods is subject to the risk that the procedures may become inadequate because of changes in conditions, and that the degree of compliance with the procedures may deteriorate.

Our study and evaluation of the company's system of internal accounting control for the year ended December 31, 19X2, which was made for the purposes set forth in the first paragraph above, would not necessarily disclose all weaknesses in the system which may have existed during the period under review. However, such study and evaluation disclosed certain ("no" if no weaknesses are disclosed) conditions that we believe to be material weaknesses. Such weaknesses, with an indication of any corrective action taken or proposed were as follows:

(a detailed description would be inserted)

We have also examined the answers to the items enumerated below which are included in the report of Sample Management Investment Company filed with the Securities and Exchange Commission on Form N-1R for the fiscal year ended December 31, 19X2; in connection therewith, we have applied such supplemental tests and other auditing procedures as we considered necessary in the circumstances.

In our opinion, the answers set forth in the following items present fairly the information they purport to show:

Items 1.03; etc.

The answers set forth in the following items are in accordance with the minutes of Sample Management Investment Company examined by us:

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*This sentence makes it clear that the independent accountant is not permitted, in reporting on internal accounting control under the requirements of Form N-1R, to use the option indicated in paragraph 640.13 of AICPA Statement on Auditing Standards No. 1 which states in part: "In some cases the auditor may conclude that for certain weaknesses corrective action by management is not practicable in the circumstances and he may decide to exclude such weaknesses from his report."

Items 1.19; etc.

The procedures which we applied were not of sufficient scope to enable us to express an opinion, and we do not express an opinion as to the answers to the following items:

Items 1.13; etc.

However, in connection with our examination, nothing came to our attention which causes us to believe that the accompanying answers to such items do not fairly set forth the information they purport to show.

We consent to the use of this opinion in connection with the filing of the report of Sample Management Investment Company with the Securities and Exchange Commission on Form N-1R.

Independent Auditor

Anytown, USA
April 21, 19X3

Implementation

Accounting changes resulting from application of the recommendation in this guide should be recognized in the auditor's report in accordance with sections 546.01-.02 of Statement on Auditing Standards No. 1.

PRO FORMA COMPUTATION OF ADJUSTMENT FOR THE REORGANIZATION OF ABC FUND, INC. INTO XYZ FUND, INC.

As of June 30, 19XX

Unaudited

	(A) ABC Fund, Inc.	(B) XYZ Fund, Inc.	(C) Total
1. Tax cost of investments	$15,000,000	$ 7,600,000	$22,600,000
2. Net unrealized appreciation (depreciation) of investment	(1,300,000)	92,000	(1,208,000)
3. Value of investments	13,700,000	7,692,000	21,392,000
4. Cash and other assets, less liabilities	2,000,000	4,000,000	6,000,000
5. Net assets at value	15,700,000	11,692,000	27,392,000
6. Net investment income and net realized gains to be distributed prior to reorganization	150,000	–	150,000
7. Net assets after distribution	$15,550,000	$11,692,000	$27,242,000
8. Percentage of combined assets	57.08%	42.92%	100.00%
9. Net realized gain (loss) to be carried forward	$ (420,000)	$ 150,000	$ (270,000)
10. Share of combined net realized gain (loss) (57.08% and 42.92%, respectively, of Line 9C)	(154,116)	(115,884)	
11. Favorable (unfavorable) change in interest in net realized capital gain or loss (Line 9 vs. Line 10)	(265,884)	265,884	$ 26,588 (Line 11 x 10%)
12. Unrealized appreciation (depreciation) to be carried forward (Line 2)	$(1,300,000)	$ 92,000	

PRO FORMA COMPUTATION OF ADJUSTMENT FOR THE REORGANIZATION OF ABC FUND, INC. INTO XYZ FUND, INC.

As of June 30, 19XX

Unaudited

	(A) ABC Fund, Inc.	(B) XYZ Fund, Inc.	(C) Total
13. Share of combined net unrealized appreciation (depreciation) (57.08% and 42.92%, respectively, of Line 2C)	(689,526)	(518,474)	
14. Favorable (unfavorable) change in interest in net unrealized appreciation or depreciation (Line 12 vs. Line 13)	$ (610,474)	$ 610,474	39,680
			(Line 14 x 6½%)
15. Upward (downward) adjustment (Line 11C plus Line 14C)			$ 66,268
16. Net assets after distribution (Line 7)	$15,550,000	$11,692,000	$27,242,000
17. Upward (downward) adjustment (Line 15)	66,268	(66,268)	–0–
18. Net assets after adjustment	$15,616,268	$11,625,732	$27,242,000
19. Total shares outstanding 6/30/XX	3,014,000	1,265,000	
Per-share amounts:			
20. Net asset value (Line 5 divided by Line 19)	$5.21	$9.24	
21. Distribution (Line 6 divided by Line 19)	(.05)	–	
22. Net asset value after distribution (Line 7 or 16 divided by Line 19)	5.16	9.24	
23. Adjustment (Line 17 divided by Line 19)	.02	(.05)	

PRO FORMA COMPUTATION OF ADJUSTMENT FOR THE REORGANIZATION OF ABC FUND, INC. INTO XYZ FUND, INC.

As of June 30, 19XX

Unaudited

	(A) ABC Fund, Inc.	(B) XYZ Fund, Inc.	(C) Total
24. Net asset value after adjustment (Line 18 divided by Line 19)	$5.18	$9.19	
25. XYZ shares to be issued for each ABC share (Line 24A divided by Line 24B)			.5638
26. Total XYZ shares to be issued for ABC shares (Line 18A divided by Line 24B)			1,699,267
Pro forma amounts:			
Net assets	$15,616,268	$11,625,732	$27,242,000
Shares outstanding	1,699,267	1,265,000	2,964,267
Net asset value per share	$9.19	$9.19	$9.19

NOTE A

	(A)	(B)	(C)
(a) Available net realized capital gain (loss) (Line 9)	$ (420,000)	$ 150,000	$ (270,000)
(b) Pro forma shares outstanding after exchange	1,699,267	1,265,000	2,964,267
(c) Realized gain (loss) per share	$ (.25)	$ .12	$ (.09)

NOTE B

	(A)	(B)	(C)
(a) Unrealized appreciation (depreciation) (Line 2)	$(1,300,000)	$ 92,000	$(1,208,000)
(b) Unrealized appreciation (depreciation) per share (B(a) divided by A(b))	$ (.77)	$ .07	$ (.41)

PRO FORMA COMPUTATION OF ADJUSTMENT FOR THE REORGANIZATION OF ABC FUND, INC. INTO XYZ FUND, INC.

As of June 30, 19XX

Unaudited

Notes to reader:

1. The purpose of adjusting the terms of an exchange (to reflect not only book net assets but, as in the above example, an estimate of the effect, on individual shareholders of each company, of unbooked contingent tax assets or liabilities relating to undistributed realized capital gains or losses and unrealized appreciation or depreciation of securities) is to give fair treatment to shareholders whose companies are undergoing a major change in their structure. The adjustment should, therefore, result in all shareholders having an equal per-share interest at the beginning of the combined operations, and a per-share amount which reflects the book net assets contributed as well as the contingent tax asset or liability assumed. The adjustment is reflected, not by adjusting the recorded aggregate net assets being contributed by both groups of shareholders, but solely by adjusting the number of shares to be issued, in order to produce identical per-share net asset values for each constituent and the pro forma combined company.

As shown in the above example, the shares outstanding immediately after the merger have a net asset value of $9.19, based on the aggregate net assets contributed by the two funds; aggregate net assets, that is, as carried on the books of the constituent funds prior to the merger. The "adjusted" net assets *ascribed* to each constituent group of shareholders also have net asset values per share of $9.19.

As indicated all shareholders should have the same net asset values per share before and after a business combination. Such equality is obtained without intangible asset/liability accounting only by adjusting both companies' net assets (solely to determine the number of shares to be issued in the merger) to reflect:

(a) What one company is receiving in the form of contingent assets or being relieved of in the form of contingent liabilities, *and*

(b) What the other company gives up in the form of contingent assets or assumes in the form of contingent liabilities.

2. Section 383 of the Internal Revenue Code reduces the capital loss carryover of the acquired company when it owns less than 20 percent of the outstanding stock of the acquiring company as meas-

ured immediately after the acquisition. The percentage of carryover allowed is five times the percentage of the combined assets after adjustment. Appropriate adjustment to Line 9 would have to be made in such cases.

3. Often ABC will be a private investment company. In such instances, the percentage on Line 14 will be 10 percent, and in most cases no adjustment will be made in favor of the private investment company.

4. The percentages on Lines 11 and 14 are somewhat arbitrary and are subject to change from time to time.

5. While the above example illustrates the way in which an adjustment might be made for tax inequalities between groups of shareholders, other adjustments, such as for extraordinary expenses of a merger, may also be appropriate in certain circumstances.

6. If securities of either company are to be sold immediately after the merger, adjustment should be made to the realized and unrealized gain or loss (Lines 9 and 12) on which the adjustment for reorganization is based.

7. The above pro forma example is adjusted to reflect actual figures at the date of merger; Lines 6 and 7 will disappear at that time.

INTERNAL REVENUE CODE WORK SHEETS

I. Code Section 851 requirements:

Assets (Quarterly computation):

A.	Cash, receivables, securities, and total other assets		$
B-1	Cash, receivables, government securities, and securities of other regulated investment companies	$	
B-2	Other securities not including either (a) securities of any one issuer having a value in excess of 5 percent of Line (A) or (b) securities representing more than 10 percent of the outstanding voting securities of any one issuer	$	
B-3	(B-1 plus B-2)		$
C.	25 percent of Line A		$

Line B-3 must be at least 50 percent of Line A

No one issue other than government securities or securities of other regulated investment companies can exceed Line C.

Income (For the taxable year to date*):

Net gain on securities sold (tax basis)	$
Add back capital losses on sales of securities	
Interest and dividends from investments	
Other income	

*This computation should be done by the company monthly so that failure to meet the requirements can be determined and corrected on a current basis.

D. Total $ ________

E. 10 percent of Line D $ ________

F. 30 percent of Line D $ ________

Other income (income other than dividends, interest and gains on securities) cannot exceed Line E.

Gains on securities held less than three months must be less than Line F.

II. Eligibility of company's ordinary income dividends for the $100 dividend exclusion and 85 percent dividends-received deduction: (Year end only)

1. Gross income (ordinary income) $ ________

2. 75 percent of Line 1 $ ________

3. Dividends from domestic corporations $ ________

If Line 3 is less than Line 2, the company must advise shareholders of the applicable portion of ordinary dividends eligible for the $100 exclusion and 85 percent dividends-received deduction.

APPENDIX C

WORK SHEET FOR DIVERSIFIED MANAGEMENT INVESTMENT COMPANIES

A. Definitions and requirements (references are to the 1940 Act and Rules thereunder):

1. "Diversified company"—a management investment company is diversified if at least 75 percent of the *value* of the company's *total* assets is represented by—

   (a) Cash and cash items (including receivables),

   (b) United States government securities,

   (c) Securities of other investment companies, and

   (d) Other securities limited in respect to any one issuer to not more than 5 percent of the *value* of the company's *total assets* and to not more than 10 percent of the outstanding voting securities of such issuer (Section 5(b)).

   A company does not lose its diversified classification where the percentage requirements are not met because of postacquisition changes in security prices (Section 5(c)).

   The portfolio requirements apply only to 75 percent of the value of the company's total assets. The remaining 25 percent need not be diversified and may be invested in the securities of a single issuer.

2. "Value," as used in Section 5—

   (a) With respect to securities owned at the end of the last preceding fiscal quarter, is the market value at the end of such quarter.

   (b) With respect to securities and other assets acquired after the end of the last preceding fiscal quarter, is the cost thereof (Section 2(a)(41)).

3. "Total assets," as used in Section 5 shall mean the gross assets of the company with respect to which the computation is made, taken as of the end of the fiscal quarter of the company last preceding the date of computation (Rule 5b-1).

B. Determine those portfolio securities which exceed 5 percent of the "value" of "total assets" at the end of each fiscal quarter.

	Quarter			
	1st	2nd	3rd	4th
1. Total assets	$	$	$	$
2. 5 percent of total assets	$	$	$	$

3. Portfolio securities at value in excess of Line 2 above:

	Quarter-end value			
Security	1st	2nd	3rd	4th
	$	$	$	$

C. If there was any purchase of the securities named in Line 3 above, during the quarter under review, it must be determined if that acquisition caused an investment of more than 5 percent of the company's total assets as follows:

Determination of total assets at acquisition date:

1. Total assets at quarter-end prior to acquisition date.

Determination of value and percent of total assets of security acquired:

2. Value of security at prior quarter-end.
3. *Add*—Purchases of security at cost including latest acquisition.
4. *Deduct*—Sales of security at prior quarter-end value.
5. Value of security acquired (Line 2 plus Line 3 less Line 4).
6. Percent of value of security acquired to total assets (Line 5 divided by Line 1).

D. Determination of issuers in which more than 10 percent of outstanding voting securities is owned:

1. By reference to current published material or other sources, determine if the company owns more than 10 percent of any issuer's outstanding voting securities; include conversion of securities convertible into voting securities.
2. Determine the percentage of value of company total assets invested in such issuers at each quarter-end.

E. For each security acquired which exceeds 5 percent as computed in Line 6 or in which the company has invested in more than 10 percent of the issuer's outstanding voting securities as computed in D.2. above, total the percentages. If the sum is 25 percent or less, the company meets the requirements of a diversified company under Section 5(b) of the 1940 Act. Of course, should the total be more than 25 percent at any time, no further investments may be made in the securities making up the 25 percent, nor in other issues if such investment would amount to more than 5 percent of the value of the total assets or more than 10 percent of the outstanding voting securities of the issuer.

UNIT INVESTMENT TRUSTS

Unit investment trusts, whose entire assets consist of securities issued by a management investment company, are noticeably different both in concept and in statement presentation from those unit investment trusts whose assets are composed of a number of portfolio securities. The former are the so-called "top trusts" or, as better known in the industry, "contractual plans."

The form and content of financial statements of unit investment trusts are prescribed by Article 6A of Regulation S-X and the accounting and auditing generally follow that described in this guide for other investment companies.

Organization

A contractual plan is usually formed by a sponsor corporation as a method of selling mutual fund shares. The sponsor acts for the investors in establishing the custodian agreement, arranging for a group creditor life insurance policy if insured plans are offered, selling the plans, and attending to the preparation of the prospectus, annual reports to the Securities and Exchange Commission and so forth. The second party to the plan is the investor, who agrees to make either a lump sum payment (a single payment plan) or a series of monthly payments over a specified period (a periodic payment plan). The third party to the plan is the custodian who receives the planholder's payment, holds the assets of the trust, and may also act as servicing agent if such is called for under the agreement. As such, he would process planholder payments, maintain the planholder accounts and attend to many related services such as crediting dividends and distributions, processing partial and full liquidations, deducting and paying insurance premiums for those accounts so electing, etc.

Financial Statements

Financial statements for a contractual plan present the accounting data for the entire plan, which is, in effect, the accumulated historical data for all the separate plan accounts. They usually include the following statements:

1. Statement of condition.
2. Statement of source of net assets (or plans outstanding or planholders' equity) by series of plans issued.

3. Statements of income and expense (or distributions received and disposition thereof).
4. Statement of changes in net assets (or shares held by custodian).

In addition, although not required, a statement of receipts and disbursements of funds is often presented.

Where information is portrayed for series of plans issued, it is usually presented for single-payment plans, monthly payment plans with insurance, and monthly payment plans without insurance. It is preferable, however, to present only single-payment and monthly payment plans as separate series, since the insurance feature is only an option available to a monthly payment planholder. It is usual to find insured plans becoming uninsured plans by request or default (sometimes with subsequent reinstatement of insurance) so that separate reporting of these plans as different series is not meaningful.

There is also presented, for a three-year period, usually in a note, the gain or loss realized by planholders on liquidation of their plans.

These financial statements are presented in the plan prospectus and annual report to the Commission on Form N-30A-2. They are not usually sent to existing planholders who receive instead the annual and semiannual reports of the mutual funds whose shares they are accumulating.[1]

Audit Considerations

The auditor should be thoroughly familiar with the method of record keeping employed by the custodian and sponsor. Detailed "inception to date" historical information must be accumulated for each plan account. Where control of historical cost data is not accomplished by the custodian's computer system, burdensome manual methods must be employed.

Customary auditing procedures are carried out with respect to examination of internal control, custodian cash accounts, share balances, and audit of transactions.

[1] Rule 30d-2 of the 1940 Act.

VENTURE CAPITAL AND SMALL BUSINESS INVESTMENT COMPANIES

Venture capital companies, including most SBICs, are different in method of operation from other types of investment companies. The usual open-end or closed-end company is a passive investor, while the venture capital company is more actively involved with its investees. In addition to providing funds, whether in the form of loans or equity, the venture capital company often provides technical and management assistance, as needed and requested, to its investees.

By the very nature of the investments, usually in securities with no public market, the portfolio of a venture capital company may be illiquid, and when gains on the investments are realized, it is often over a relatively long holding period. As mentioned in Chapter 2, the nature of the investments requires valuation procedures which differ markedly from those employed by the typical investment company with which this guide deals primarily.

Venture capital companies may incur liabilities not generally found in other investment companies. Leverage opportunities available to the owners of these companies are not available to open-end companies and are not often found in closed-end companies. SBICs, by statute, may borrow from the Small Business Administration (SBA), often at advantageous rates, up to two or three times their paid-in capital. (Although a $150,000 minimum capital is required for SBICs, the usual level is $300,000 to $500,000, and where there is adequate capital, loans up to $20,000,000 may be obtained.)

Also, many venture capital companies, including most SBICs, are privately owned or closely-held, are not regulated under the Investment Company Act of 1940, and do not have as great a concern with reporting to public shareholders.

While all of these companies must prepare their financial statements in accordance with generally accepted accounting principles and are subject to audit as are other investment companies, the statement presentation of some companies may need to be tailored to present the information in the most meaningful manner to their particular group of investors. For instance, where debt is a significant item, a balance sheet might be more appropriate than a statement of net assets. Also, different regulatory procedures may apply. Publicly-owned SBICs are subject to the provision of Article 5 of Regulation S-X, while other publicly owned venture capital companies are subject to Article 6.

The unique features (primarily the existence of significant debt) of an SBIC often make it desirable that their financial statements be presented in a conventional balance sheet format. SBICs are regulated by the SBA and accordingly are required to comply with

Part 107 of the SBA rules and regulations. In addition, a series of Policy and Procedure Releases deals with specific aspects of SBA regulation. Release 2012 will constitute an Audit and Examination Guide for Small Business Investment Companies, which will govern the specific audit procedures and reporting requirements (e.g., on Form 468) the SBA wishes to have completed. Release 2014 will contain the System of Account Classification and Release 2006 deals with guidance to SBICs as to proper techniques and standards to be followed in valuing their portfolios. The auditor of an SBIC should be familiar with these publications.

Also, there exists at this time a variation in format for reporting results of operations of SBICs from that set forth for other investment companies in this guide. The auditor should maintain current knowledge of changes in SBA regulation in this area of reporting.

ILLUSTRATION* OF REPORT PRESENTATION FOR A MERGER ACCOUNTED FOR AS A PURCHASE FOR FINANCIAL REPORTING PURPOSES AND TREATED AS A NONTAXABLE EXCHANGE FOR TAX PURPOSES

Statement of Changes in Net Assets

	19X2	19X1
From Investment Activities		
Net investment income	$ 637,000	$ 575,000
Undistributed investment income included in price of shares issued and repurchased	9,000	6,000
	646,000	581,000
Dividends to shareholders	645,000	568,000
Increase in undistributed net investment income	1,000	13,000
Net realized gains from security transactions	877,000	1,239,000
Distributions to shareholders (including $75,000 in 19X2 of additional taxable security gains arising from sale of investments acquired in nontaxable mergers) (Note 3)	1,314,000	1,060,000
Increase (decrease) in undistributed security gains	(437,000)	179,000
Increase (decrease) in unrealized appreciation of investments	(2,611,000)	1,229,000
Increase (decrease) in net assets derived from investment activities	(3,047,000)	1,421,000
From Capital Share Transactions (exclusive of amounts allocated to investment income) (Note 4):		
Net proceeds from sale of shares	1,948,000	1,440,000

* This illustration is identical to the Statement of Changes in Net Assets illustrated in Chapter 7 except for the items relating to the mergers in 19X1 and resulting transactions in 19X2.

	19X2	19X1
Net asset value of shares issued to shareholders in distribution of net investment income and realized gain from security transactions	1,000,000	845,000
Fair value (net asset value) of shares issued in exchange for assets (investments) acquired in mergers (including $325,000 of unrealized appreciation on investments at date of acquisition)		1,000,000
	2,948,000	3,285,000
Cost of shares repurchased	456,000	530,000
Increase in net assets derived from capital share transactions	2,492,000	2,755,000
Net increase (decrease) in net assets	(555,000)	4,176,000
Net Assets		
Beginning of period	18,792,000	14,616,000
End of period (including undistributed net investment income of $36,000 in 19X2 and $35,000 in 19X1)	$18,237,000	$18,792,000

Notes to Financial Statements

3. Distributions

Realized gains from security transactions are distributed to shareholders in the succeeding year. At December 31, 19X2 undistributed realized security gains amounted to $927,000 of which $50,000 was realized from investments acquired in nontaxable mergers.

A distribution of 22¢ a share aggregating $936,000 was declared on January 10, 19X3 payable January 20, 19X3, which distribution included the $50,000 mentioned above.

4. Capital Stock

At December 31, 19X2, there were 5,000,000 shares of $.50 par value capital stock authorized, and paid-in capital aggregated $15,947,000.

Included in paid-in capital $200,000 which represents the remaining amount of unrealized appreciation acquired in nontaxable mergers (originally $325,000).

Transactions in capital stock were as follows:

	19X2	19X1
Shares sold	452,000	329,000
Shares issued to shareholders in reinvestment of net investment income and realized gain from security transactions	222,000	207,000
Shares issued in exchange for assets (investments) acquired in merger	–	250,000
	674,000	786,000
Shares reacquired	104,000	121,000
Net increase	570,000	665,000

Supplementary Information

	For the years ended December 31				
	19X2	19X1	19X0	19X9	19X8
Investment income	$.17	$.17	$.17	$.16	$.15
Etc.					
Distribution from net realized gain from security transactions	(.36)*	(.33)	(.24)	(.23)	(.20)

* Distribution from security gains includes $.02 in 19X2 of additional security gains arising from sale of investments acquired in nontaxable mergers.

ILLUSTRATIVE REPRESENTATION LETTER

January 21, 19X3

Accounting Firm

Gentlemen:

We are writing at your request to confirm our understanding that the examination which you have made was directed to the expression of an opinion on the financial statements of Sample Management Investment Company for the year ended December 31, 19X2, and that auditing procedures, including tests of our accounting records, were limited to those which you considered necessary in the circumstances on the basis of generally accepted auditing standards.

Also at your request, to supplement information obtained by you from the books and records of the Company and from other sources, we advise you that, to the best of our knowledge and belief, the Company at December 31, 19X2, had—

(1) Portfolio securities in the aggregate amount of $__________ which are stated at value as determined in accordance with the valuation method set forth in the current prospectus. All portfolio securities are marketable and no restricted securities are held. (State exceptions, if any. See following paragraph.) The cost of portfolio securities of $________ was determined on the basis of ("identified cost," "FIFO," "LIFO," or other basis) consistent with the prior year. All Company investments during (period of examination) were made in accordance with the investment policies stated in the current prospectus.

(2) Restricted securities in the amount of $__________ (__ percent of net assets) which are stated at fair value as determined in good faith by the board of directors. (Describe methods used.)

(3) No assets pledged or assigned as security for liabilities, performance of contracts, etc., except as disclosed in the financial statements or notes thereto.

(4) No material unrecorded assets or contingent assets (such as claims relating to buy-ins, unfulfilled contracts, etc., whose value depends on fulfillment of conditions regarded as uncertain).

(5) No material unrecorded liabilities or undisclosed contingent liabilities (endorsements or guarantees, lawsuits, additional taxes for prior years, repurchase agreements, etc.).

(6) Complied with the provisions of the Investment Company Act of 1940 and the rules and regulations thereunder, complied with the

provisions of its prospectus and the requirements of the various "Blue Sky" laws under which the Company operates, and qualified as a regulated investment company pursuant to Subchapter M of the Internal Revenue Code. The daily net asset value has been properly computed throughout the year in accordance with Rule 2a-4 of the Investment Company Act of 1940 and correctly applied in the computation of daily capital stock sales and redemption transactions.

(7) Not made any commitments during the year as underwriter in foreign currencies and/or spot (cash) commodity contracts.

(8) Not engaged in any transactions made on margin, in joint trading, or selling short.

Furthermore—

(9) The Company intends to continue its qualification as a regulated investment company.

(10) The Company, except to the extent indicated in its financial statements, does not own any securities of persons who are directly affiliated. (Affiliated person being (a) any person directly or indirectly owning, controlling, or holding with power to vote, five per centum or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by such other person; (b) any person directly or indirectly controlling, controlled by, or under common control with, such other person; (c) any officer, director, partner, copartner, or employee of such other person; (d) if such other person is an investment company, any investment adviser thereof or any member of an advisory board thereof; and (e) if such other person is an unincorporated investment company not having a board of directors, the depositor thereof.)

(11) The Company has not received income from (or realized gain or loss on sales of investments in or indebtedness of) such affiliated persons.

(12) The Company has not incurred expenses for management or other service fees payable to such affiliated persons and has not otherwise engaged in transactions with such affiliated persons, except with ——————————————, its investment manager and underwriter.

Further, we advise you that, to the best of our knowledge and belief, all accounting and financial records and related data of the Company, including all corporate minutes through January ——, 19X3, have been made available to you, and as far as we know none of them were withheld from you. The Company has not entered into any agreements not in the ordinary course of business, nor have any other matters or occurrences come to our attention up to the present time which would materially affect the financial statements for the (period of examination) (except—refer to matters or occurrences of which the client is aware). In addition, we know of no event since December 31, 19X2, which, although not affecting such financial statements, has caused or is likely to cause any material change, adverse or otherwise, in the net asset value, financial position, or the results of operations of the Company.

Very truly yours,

Sample Management Investment Company

____

Chief Executive Officer

____

Chief Financial Officer

Glossary

Accounting Series Release. Opinions issued periodically by the Securities and Exchange Commission for the purpose of contributing to the development of uniform accounting standards and practices and to define the Commission's position on such other areas as auditing, independence, etc.

Accrued interest. Interest accrued on a debt instrument, such as a bond since the last interest payment was made. A purchaser of a bond pays the market price plus accrued interest. Exceptions include bonds which are in default (flat bonds) and income bonds (which do not pay interest unless earned and declared).

Accumulation plan. An investment plan under which an investor may make regular purchases of investment company shares in specified minimum amounts. Reinvestment of dividends and distributions is usually made automatically. Sometimes called "Systematic Plan." *See* Contractual plan.

Adviser. *See* Investment adviser.

Advisory and service fee (contract). *See* Investment advisory fee (contract).

Affiliated company (as defined by the 1940 Act). A company in which there is any direct or indirect ownership of five per cent or more of the outstanding voting securities. *See* Controlled affiliates. *See also* Regulation S-X.

Asked price. A potential seller's lowest acceptable price for a security.

Balanced fund. An investment company which emphasizes both growth and income by investing in both equity and fixed income securities.

Bid price. A potential buyer's highest acceptable price for a security.

Blue Sky laws. The popular name for state statutes regulating the offering or sale of corporate securities, bonds, investment contracts and stocks.

Bond. An interest-bearing certificate of indebtedness.

Bond discount. The difference between the face amount of a bond and the lower price paid by the buyer.

Bond fund. An investment company whose security holdings are invested principally in bonds.

Book shares. Mutual fund share ownership evidenced by confirmation from transfer agent (registrar) rather than by physical stock certificates.

Break point. The level of quantity purchased at which a lower sales charge takes effect.

Broker. An agent, often a member of a stock exchange firm or an exchange member himself, who executes orders to buy or sell securities or commodities, for which a commission is charged.

Bunching. The grouping together of transactions in the same security for several investment clients of the same investment adviser in order to obtain the benefit of lower commission charges.

Call option. A contract which entitles the holder to buy (call) entirely at his option, a specified number of shares of a particular stock at a specified price at any time until the stated expiration date of the contract. Such an option (which is always for a round lot amount and which is transferable) is bought in the expectation of a price rise above the contract price. If the price rise occurs, the purchaser will exercise the option. If the rise does not occur, the purchaser will let the option expire and will lose only the cost of the option. During the existence of the option, the exercise price and number of shares is adjusted on the ex-date for cash dividends rights and stock dividends or splits.

Capital gain or loss. Profit or loss realized from the sale of capital assets, such as portfolio securities, as defined in the Internal Revenue Code.

Capital gain distribution. A distribution of realized capital gains made to its shareholders by a regulated investment company.

Churning. The process of unnecessary purchases and sales of portfolio securities for the purpose of generating commissions.

Closed-end fund. An investment company having a fixed number of shares outstanding which it does not stand ready to redeem. Its shares are traded similarly to those of other public corporations.

Closed-up fund. An open-end investment company which has discontinued offering its shares for sale to the general public, but still stands ready to redeem its outstanding shares.

Collective (Common) trust fund. A collective investment fund organized and administered by a bank or trust company for the benefit of its own trust account customers.

Common stock. The class of capital stock of a corporation generally having voting rights and which, after the requirements of preferred classes have been met, participates in dividends or, after the liabilities and other priority claims have been satisfied, in the ultimate distribution of corporate assets.

Contractual plan. A type of accumulation plan under which the total of the intended investment is specified with provisions for periodic payments over a stated period. A substantial portion of the sales charge applicable to the total investment is usually deducted from early payments and, because of this method of deducting charges, the plans are sometimes called "front-end load" plans.

Control. The power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of an official position with such company.

Controlled affiliate (as defined by the 1940 Act). Direct or indirect ownership of more than twenty-five percent of the outstanding voting securities of a company is presumed to be control; however, such control can be disclaimed. *See* Affiliated company.

Convertible securities. A bond or a preferred stock that may be exchanged by the owner for common stock or other security of the issuing corporation.

Custodian. A bank or trust company (or, less frequently, a member of a national securities exchange) which is held responsible for the receipt, delivery, and safekeeping of an investment company's cash and securities.

Dealer. A person or firm acting as a principal rather than as an agent in the purchase and sale of securities. Mutual fund shares are usually sold through dealers.

Depositor. A person primarily responsible for the organization of an unincorporated investment trust (usually a unit investment trust) and who has continuing responsibilities with respect to administration of the affairs of the trust, other than the trustee or custodian. See also General Instructions to Form N-1R.

Designated capital gains. Realized capital gains which are retained by the investment company. The federal income tax thereon is paid by the company, for the account of the shareholders of record on the last day of the year; the shareholders report the income and take credit for the tax on their own returns.

Distribution. Payment made from realized capital gains. *See* Capital gain distribution.

Distributor. Usually the principal underwriter who performs the selling function for the mutual fund by acting as an agent (intermediary between fund and independent dealer or public) or acting as a principal buying capital shares from the fund at net asset value and selling shares through dealers or to the public.

Diversification. Investment in more than one security issue for the purpose of spreading and reducing the risks inherent in investment.

Diversified investment company. A management investment company having at least seventy-five percent of its total assets in cash and cash items (including receivables), government securities, securities of other investment companies, and other securities limited to not more than five percent of its total assets in any one issuer and to not more than ten percent of the voting securities of any one issuer (Section 5 of the 1940 Act).

Dividend. Payment made to shareholders from net investment income.

Dual-purpose fund. Closed-end investment company with two classes of shares—income shares for those interested in income and capital shares for those interested in capital growth.

EDP. Abbreviation for electronic data processing.

Equalization. *See* Income equalization.

Equity securities. Term applied to common stocks or to debentures or to preferred stock convertible into common stocks.

Exempt securities. Securities exempted from registration under the Securities Act of 1933 or the Securities Exchange Act of 1934, otherwise than by action of the Securities and Exchange Commission.

Expense limitation. An arrangement between an investment company and its investment adviser whereby the adviser agrees to restrict its fee, usually based on a stipulated relationship between total expenses and average net assets.

Ex-dividend or ex-distribution. A synonym for "without dividend." The buyer of a stock selling ex-dividend does not receive the recently declared dividend; distribution refers to capital gain distributions.

Ex-rights. Similar to ex-dividend. The buyer of stock selling ex-rights is not entitled to the rights distribution.

Extra or extra dividend. Refers to a cash dividend that has been declared by a corporation in addition to its usual dividend.

Ex-warrants. On occasion stocks or bonds have warrants attached entitling the holder to subscribe to additional shares within specified periods of time and at specified prices. When these warrants are detached the security is traded "ex-warrants."

Face amount. Usually the dollar amount that appears on the face of a bond and that the issuing corporation has promised to pay to the holder at a fixed date.

Face-amount certificate. A security representing an obligation of the issuer to pay a stated amount at a fixed date in the future, the consideration for which is either payment of periodic installments of a stated amount or a single lump payment.

Face-amount certificate company. An investment company engaged in the business of issuing face-amount certificates of the installment type.

Fails. Security transactions between two parties which have not been settled at the settlement or clearance date.

Fail-to-deliver. Securities which the selling brokerage concern or other financial institution has not delivered to the purchaser at the settlement or clearance date.

Fail-to-receive. Securities which the purchasing brokerage concern or other financial institution has not received from the seller at the settlement or clearance date.

Fair value. Value determined for those securities and assets for which there are no market quotations readily available.

Fixed-income security. A preferred stock or bond with a stated amount of income return.

Flat. A method of trading in certain types of bonds. Usually used in trading income bonds which do not pay interest unless it has been earned and declared payable, or bonds on which the issuing corporation has defaulted in the payment of interest. When bonds are traded "flat" the seller is not entitled to receive (in addition to the price of the bond) the interest that has accumulated since the date of the last interest payment. The seller of a bond that is traded "flat" must deliver the bond with all unpaid coupons attached or a due bill authorizing the buyer to collect any payments of interest that may be made by the issuing corporation in the future.

Forward pricing. The pricing of mutual fund shares for sale, repurchase or redemption at the price next computed after the receipt of an order.

Fractional share. A portion of a full share of stock.

Front-end load plans. *See* Contractual plan.

Give-up. Type of order given by a brokerage firm's customer to another firm on whose books the customer does not have an account. The Securities and Exchange Commission banned the give-up practice in 1968. Prior to that date, mutual funds sometimes directed one broker to "give up" part of his commission for executing security transactions to certain other brokers as an incentive for selling fund shares to the public or for other services.

Growth fund. An investment company investing primarily or entirely in growth industry securities.

Growth stock. Used to describe the stock of a company whose earnings are expected to increase and so result in increasing the market value of the stock. Growth stock companies generally reemploy a substantial part of their earnings rather than pay them out in cash dividends.

Guaranteed securities. Bonds or stocks for which the payment of interest or dividends is guaranteed by a company other than the issuing company. With respect to bonds the guarantee may also include the payment of principal.

Handshake date. The date on which a price and other general terms are determined, usually used with respect to a private securities transaction. See Accounting Series Release No. 113.

Hedge fund. An investment company seeking to minimize market risks by holding securities believed likely to increase in value and at the same time being "short" other securities believed likely to decrease in value. The sole objective is capital appreciation.

Holder of record. The party listed as the registered owner on the transfer records of a corporation. This might be the actual owner, a brokerage concern holding the security for the owner, or someone who has sold the security on which the registration has not yet been changed.

Inadvertent investment company. An industrial or service type company which is deemed to be an investment company when it "inadvertently" meets the criteria of Section 3(a) of the 1940 Act. It must then register under and comply with the provisions of that Act.

Incentive compensation. A fee paid to an investment company's adviser which generally consists of a basic fee plus a bonus (or less a penalty) if the fund's performance exceeds (or fails to match) that of a specified stock index.

Income equalization. An accounting method utilized to prevent a dilution of the continuing shareholders' per-share equity in undistributed net investment income. Dilution is caused by the continuous sales and redemptions of capital shares.

Income fund. An investment company whose prime aim is to maximize income. It would be expected to invest substantially in high yield common and preferred stocks and debt securities.

Investment adviser (manager). A person, usually a company providing investment advice, research, and often administrative and similar services for a fee, generally based upon a percentage of net assets, as provided by a contract.

Investment Advisers Act of 1940. Controls almost any person who, for compensation, renders investment advice to individuals or institutions, including investment companies.

Investment advisory fee. The charge made to an investment company by its investment adviser, under a contract approved by a majority of the company's shareholders. The fee is generally computed as a percentage of the average net assets, and may also provide for an additional bonus (or penalty) based on performance. *See* Incentive compensation.

Investment company. A pooling of funds by their collective owners to avail themselves of professional investment management and diversification of investments.

Investment Company Act of 1940, as amended. Provides for the registration and regulation of investment companies. Amended by Investment Company Amendments Act of 1970.

Investment company trade associations. Such associations as the Investment Company Institute (ICI), the National Association of Small Business Investment Companies (NASBIC) and the Association of Closed-End Investment Companies.

Letter of intent. Agreement by which a shareholder agrees to purchase a specified dollar amount of mutual fund shares, usually over a thirteen-month period, in return for a reduced sales charge that would apply to a comparable lump-sum purchase.

Letter stock. *See* Restricted security.

Listed security. A security which is listed and traded on a stock exchange.

Load. *See* Sales charge.

Long. Denotes ownership of securities.

Management company. Any investment company other than a face-amount certificate company or a unit investment trust. Also sometimes used to refer to the investment adviser of an investment company.

Management fee. *See* Investment advisory fee.

Market price. Usually means the last reported price at which a security has been sold.

Mutual fund. The popular name for an open-end management investment company. *See* **Open-end investment company.**

NASDAQ. An electronic quotation system for the over-the-counter market.

National Association of Securities Dealers, Inc. (NASD). An association of broker-dealers who do business in the over-the-counter market. The Association supervises and regulates the trading conduct of its members.

Net assets. The term used by an investment company to designate the excess of the value of securities owned, plus cash, receivables, and other assets over the liabilities of the company.

Net asset value. The value per share of outstanding capital stock of an investment company, usually computed daily, by dividing net assets by the total number of shares outstanding.

Net investment income. Income from dividends and interest on an investment company's investments, and all other sources except realized and unrealized gains or losses from security transactions, less operating expenses other than income taxes on realized gains from security transactions.

New issue. A security that is sold publicly by an issuing corporation for the first time.

No-load fund. A mutual fund selling its shares at net asset value without the addition of sales charges.

Nominee. A person or company in whose name a security may be registered, such person or corporation not being the true owner.

Odd lot. A quantity of securities which is less than the trading unit. Usually a quantity less than an even one hundred shares.

Offer. The lowest price at which a seller is willing to sell a security.

Offering price. The price at which mutual fund shares can be purchased, which often represents net asset value plus a "load."

Offshore fund. An investment company, incorporated outside the United States, the shares of which are held solely by foreign investors. An offshore fund presently is not subject to regulation by the Securities and Exchange Commission.

Open contract. An unexecuted contract. Usually in connection with new issues which are traded "when, as, and if issued."

Open-end investment company. A mutual fund which stands ready to redeem its shares at any time, and usually offers its shares for sale to the public on a continuing basis.

Optional dividend. A dividend that is payable in either stock or cash at the option of the holder of record.

Original issue discount. A federal income tax term of interest to the holder of a bond, representing the difference between the face amount of a bond and its original sales price.

Over-the-counter (OTC). A market for securities made up of brokerage concerns who may or may not be members of a security exchange. Securities are traded between brokerage concerns who act either as principals or as brokers for customers. The over-the-counter market is the principal market for United States government and municipal obligations.

Passed dividend. A regular dividend that has not been declared by the directors of a corporation.

Payable date. The date on which a dividend is payable to holders of record as of a prior date.

Performance fee. *See* Incentive compensation.

Periodic payment plan. *See* Accumulation plan.

Pink sheets. A listing of over-the-counter securities published by the National Quotation Bureau. It shows the most recent bid and asked prices for the securities listed, as well as the broker-dealers making a market in those securities. While pink paper is used for stock quotations the term also applies to listings of bond quotations and other types of securities which are printed on paper of different color.

Portfolio. The securities owned by an investment company or other investor in securities.

Portfolio turnover rate. A measure of portfolio activity. For an investment company, it is generally calculated by dividing the lesser of purchases or sales of portfolio securities, excluding transactions in United States government securities and short-term paper, by the average value during the period of the portfolio securities.

Preferred stock. The class of capital stock of a corporation generally carrying a fixed dividend whose claim to earnings and assets must be paid before common stock is entitled to share.

Premium on repurchases. A percentage of net asset value which may be charged on repurchases of an open-end investment company's shares.

Price make-up sheet. The detailed computation of the net asset value of a mutual fund.

Principal. A dealer who buys or sells securities for his own account acts as a "principal." Also the face amount of a security, i.e., exclusive of accrued interest.

Private placement. The direct sale of a block of securities, either a new issue or a secondary issue, to a single investor or group of investors. This is usually accomplished through an investment banker and the securities are usually restricted as to resale. *See* Restricted security.

Prospectus. A circular which describes securities being offered for sale to the public. Required by the Securities Act of 1933.

Proxy. A person who is authorized to vote the shares of an absent shareholder at a meeting of shareholders. Also means the written authorization given to such person.

Proxy statement. A document containing specified information that must be sent to shareholders at the time they are asked to sign proxies for a meeting of shareholders.

Put option. A contract which entitles the holder to sell (put), entirely at his option, a specified number of shares of a particular security at a specified price anytime until the expiration date of the contract. *See also* Call option.

Quote. The price of a security. It may be the price of the last sale made on an exchange or the current bid and asked price.

Realized gain or loss. *See* Capital gain or loss.

Record date. The date on which an owner of stock must be registered on the books of a company as a shareholder in order to receive a declared dividend or, among other things, to vote on company affairs.

Redemption. Presentation of share or book certificates by the stockholder to the investment company, or a person designated by the investment company, for liquidation of such shares.

Redemption in kind. Redemption of investment company shares for which payment is made in portfolio securities rather than cash. Generally applied only to tax-free exchange funds.

Redemption or repurchase price. The price, generally net asset value, at which a share of a mutual fund is redeemed or repurchased.

Registered bond. A bond which is registered in the name of the owner on the books of the issuing company.

Registered investment company. An investment company that has filed a registration statement with the Securities and Exchange Commission in accordance with the requirements of the Investment Company Act of 1940, which statement has been declared effective by the Commission.

Registrar. Usually a banking institution charged with the responsibility of preventing the issuance of more stock than that authorized by the issuing company.

Regulated investment company. An investment company that qualifies for the special tax treatment provided by Subchapter M of the Internal Revenue Code.

Regulation S-X. Accounting rules for form and content of financial statements required under the Securities Act of 1933, Securities Exchange Act of 1934, Public Utility Holding Company Act of 1935, and Investment Company Act of 1940. Article 6 applies to investment companies.

Release. Periodic releases are issued by the Securities and Exchange Commission under each of the several acts which it administers.

Repurchase. Liquidation of investment company shares through a principal underwriter or a broker-dealer on behalf of shareholders.

Repurchase agreements ("repos"). An agreement whereby the seller of securities agrees to repurchase the securities within a specified time at a specified price.

Restricted security. A portfolio security which may be sold privately, but requires registration with, or exemption therefrom by, the Securities and Exchange Commission before it may be sold publicly. A private placement frequently referred to as "letter stock."

Return. *See* Yield.

Reverse split. Opposite of "stock split."

Right of accumulation. A method of permitting a reduced sales charge on a single purchase by aggregating shares previously acquired and presently owned plus those being acquired to qualify for a "quantity discount."

Rights. The privilege offered by a corporation to its shareholders to subscribe to certain securities at a specified price.

Sales charge. An amount added to the net asset value of an open-end investment company's shares, in computing the offering price, to provide for the underwriters and dealers commissions; generally stated as a percentage of the offering price.

Securities Act of 1933. See Chapter 1 of this guide.

Securities and Exchange Commission. An agency established by Congress to administer federal securities laws.

Securities Exchange Act of 1934. See Chapter 1 of this guide.

Settlement date. The date on which security transactions are to be settled by the delivery or receipt of securities and the receipt or payment of cash.

Short sale. A sale of securities not yet owned with the expectation that the price will go down so that it can then be repurchased at a profit. The person making a short sale borrows equivalent securities to make delivery to the buyer, and must eventually purchase the securities to return to the lender.

Small Business Administration (SBA). An agency established by Congress to administer the Small Business Investment Company Act of 1958.

Small business investment company (SBIC). An investment company registered under the Small Business Investment Company Act of 1958 to provide capital for small business enterprises.

Split or stock split. The action of increasing the number of outstanding shares of stock of a company so as to decrease the market price, i.e., two shares for each share held will have the effect of reducing the price of the shares by approximately one half.

Spread. A combination of a "put" and "call" option at different prices; one below and the other above the current market price. Also refers to the difference between the bid and asked prices of a security and to the dealer's commission on a security offering.

Stock dividend. A dividend payable in stock of the issuing corporation.

Stockholder of record. A stockholder whose name is registered on the books of the issuing corporation.

Straddle. A combination of one "put" and one "call" option, identical with respect to the security issue, number of shares, exercise price, and expiration date.

Street name. Securities held in the name of a brokerage concern instead of in customers' names are said to be carried in "street name."

Swap fund. *See* Tax-free exchange fund.

Tax-free exchange fund (swap fund). An investment company organized between 1960 and 1967 to permit investors holding individual securities selling at appreciated prices to exchange such securities, without payment of capital gains tax, for shares of the fund. Unless new legislation is enacted by Congress, no additional funds of this type can be created.

Ticker. An instrument that prints the price at which a security has been traded on an exchange a short time after the trade is made.

Trade. A term that indicates the execution of a security transaction, either a purchase or a sale.

Trade date. The date an order for a security transaction is executed.

Transfer. Usually refers to the act of changing the ownership of registered securities on the books of the issuing corporation.

Transfer agent. The appointed agent issuing, transferring, repurchasing, and accounting for shares of an investment company. The transfer agent keeps a record of the name of each registered shareholder, his or her address, and the number of shares owned and sees that certificates presented to his office for transfer are properly cancelled and new certificates issued in the name of the transferee.

Underwriting. The act of distributing a new issue of securities (or a large block of issued securities, i.e., a secondary offering).

Unit investment trust. An investment company organized under a trust indenture that issues only redeemable securities, each of which represents an individual interest in the unit of specified securities.

Unlisted security. A security which is not listed on a securities exchange.

Unrealized appreciation or depreciation. The excess (appreciation) or deficiency (depreciation) of the value of portfolio security holdings over (under) cost.

Variable annuities. A variable annuity is a contract under which the annuitant purchases his annuity with a fixed number of dollars which are translated into a varying number of accumulation units. At retirement he is paid in a fixed number of annuity units monthly which are translated into a varying number of dollars. The value of both accumulation and annuity units varies in accordance with the performance of an investment portfolio invested in equity securities, primarily common stock. Variable annuities do not guarantee a fixed amount of income. They guarantee monthly payments for life, but the dollar amounts of income will vary from month to month. During periods of rising stock prices, the dollar amounts of income payments may be expected to increase. However, in a market decline, the dollar amounts of the monthly payments will be decreased.

Venture capital investment company. A closed-end investment company whose primary investment objective is capital growth and whose capital is invested in restricted securities at high risk, in negotiated transactions, to form or develop companies with new ideas, products, or processes.

Warrants. Rights to purchase additional securities, usually affixed to the certificates at the time securities are originally issued. Also refers to document evidencing rights, i.e., a warrant for 125 rights.

Yield. Income received from investments, usually expressed as a percentage of market price; also referred to as "return."

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Statement of Position on FINANCIAL ACCOUNTING AND REPORTING BY FACE-AMOUNT CERTIFICATE COMPANIES

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American Institute of Certified Public Accountants

NOTES

The American Institute of Certified Public Accountants has issued a series of industry-oriented Audit Guides that present recommendations on auditing procedures and auditors' reports and in some instances on accounting principles, and a series of Accounting Guides that present recommendations on accounting principles. Based on experience in the application of these Guides, AICPA Task Forces may from time to time conclude that it is desirable to change a Guide. A Statement of Position is used to revise or clarify certain of the recommendations in the Guide to which it relates. A Statement of Position represents the considered judgment of the responsible AICPA Task Force.

To the extent that a Statement of Position is concerned with auditing procedures and auditors' reports, its degree of authority is the same as that of the Audit Guide to which it relates. As to such matters, members should be aware that they may be called upon to justify departures from the recommendations of the Task Force.

To the extent that a Statement of Position relates to standards of financial accounting or reporting (accounting principles), the recommendations of the Task Force are subject to ultimate disposition by the Financial Accounting Standards Board. The recommendations are made for the purpose of urging the FASB to promulgate standards that the Task Force believes would be in the public interest.

AICPA American Institute of Certified Public Accountants
1211 Avenue of the Americas, New York, New York 10036 (212) 575-6200

December 10, 1974

Marshall S. Armstrong, CPA
Chairman
Financial Accounting Standards Board
High Ridge Park
Stamford, Connecticut 06905

Proposal to Amend
AICPA Industry Audit Guide on
Audits of Investment Companies
With Respect to
<u>Face-Amount Certificate Companies</u>

Dear Mr. Armstrong:

The accompanying Statement of Position, prepared by the Accounting Standards Task Force on Investment Companies, proposes amendments to the AICPA Industry Audit Guide on <u>Audits of Investment Companies</u> which would exclude face-amount certificate companies from the general definition of investment companies set forth in the Guide. Accordingly, these companies (there are four in active operation at the present time) would not be required to follow the accounting provisions of the Guide.

While issuance of this Statement of Position will be helpful to independent auditors, we urge that FASB advise the accounting profession at an early date as to whether it believes the proposed amendments are appropriate and should be regarded as having the same authoritative support as the Audit Guide itself.

Members of the Task Force will be glad to meet with you or your representatives to discuss this proposal. The Task Force would also appreciate being advised as to the Board's proposed action on its recommendations.

Sincerely yours,

ACCOUNTING STANDARDS TASK FORCE ON INVESTMENT COMPANIES

James H. Muller, Chairman	Edwin N. Hanlon
Charles Adams	William T. Kennedy
Philip L. Cohen	David A. O'Keefe
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Robert J. Gummer	John Woodcock, Jr.

Audits of Face-Amount Certificate Companies

Background Information

The AICPA Industry Audit Guide sets forth the following general definition of the investment company industry:

> The business of an investment company consists of selling its capital shares to the public, investing the proceeds—for the most part in securities—in a manner seeking to achieve its announced investment objectives, and distributing to its shareholders the net income from, and the net gains realized on sales of, its investments. Generally, an investment company can be said to be a pooling of funds by shareholders to avail themselves of professional investment management.[1]

The Guide then includes face-amount certificate companies as investment companies to which the Guide is applicable by the following:

> Within the umbrella of the above general definition fall many forms of investment companies, including management investment companies, *face-amount certificate companies* (emphasis supplied), unit investment trusts, collective trust funds, investment partnerships, and "offshore funds".[2]

In its Glossary, the Guide defines a face-amount certificate as "A security representing an obligation of the issuer to pay a stated amount at a fixed date in the future, the consideration for which is either payment of periodic installments of a stated amount or a single lump payment." A face-amount certificate company is

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[1] AICPA, *Audits of Investment Companies* (New York: 1973), p. 1.
[2] *Ibid.*

"An investment company engaged in the business of issuing face-amount certificates of the installment type."[3]

The task force has reconsidered the appropriateness of including face-amount certificate companies in the definition of "investment companies" included in the Guide.

Recommendation

The Task Force believes that face-amount certificate companies do not fall within the general definition of investment companies set forth in the Guide and, therefore, such companies should not be required to follow the accounting provisions of the Guide.

Specifically, the Task Force believes that *Audits of Investment Companies* should be amended as follows:

(a) The phrase "face-amount certificate companies," should be deleted from the first sentence of the second paragraph on page 1 of the Guide.

(b) The definition of a face-amount certificate company on page 141 of the Guide should be changed to read, "A company (not an "investment company" as defined elsewhere herein, but subject to the provisions of the Investment Company Act of 1940) engaged in the business of issuing face-amount certificates of the installment type."

Reasons for Recommendations

The Guide's definition of an investment company quoted earlier in this Statement of Position is not met by face-amount certificate companies for the following reasons:

(a) The business of a face-amount certificate company does not consist of "selling its capital shares to the public." Such companies (there are only four in active operation at the present time) are in the business of selling certificates which are fixed obligations and liabilities of the company.

(b) A face-amount certificate company does not distribute to its certificate holders "the net income from, and the net gains realized on sales of, its investments."

[3] *Ibid*, p. 141.

(c) A face-amount certificate company does not pool funds obtained from its shareholders. It pools the funds obtained from its certificate holders with the hope that the investments made will both satisfy the company's obligations to those certificate holders and result in a profit for shareholder(s).

Because of these essential differences between face-amount certificate companies and investment companies, which were not recognized in the Guide, it is not appropriate to define face-amount certificate companies as a type of investment company for the purposes of the Guide and, therefore, such companies should not be required to follow the accounting provisions of the Guide.

Statement of Position on FINANCIAL ACCOUNTING AND REPORTING BY INVESTMENT COMPANIES

77-1

April 15, 1977

**Proposal to Financial Accounting Standards Board
to Amend AICPA Industry Audit Guide
on Audits of Investment Companies**

**Issued by Accounting Standards Division
American Institute of Certified Public Accountants**

NOTES

The American Institute of Certified Public Accountants has issued a series of industry-oriented Audit Guides that present recommendations on auditing procedures and auditors' reports and in some instances on accounting principles, and a series of Accounting Guides that present recommendations on accounting principles. Based on experience in the application of these Guides, AICPA Task Forces may from time to time conclude that it is desirable to change a Guide. A Statement of Position is used to revise or clarify certain of the recommendations in the Guide to which it relates. A Statement of Position represents the considered judgment of the responsible AICPA Task Force.

To the extent that a Statement of Position is concerned with auditing procedures and auditors' reports, its degree of authority is the same as that of the Audit Guide to which it relates. As to such matters, members should be aware that they may be called upon to justify departures from the recommendations of the Task Force.

To the extent that a Statement of Position relates to standards of financial accounting or reporting (accounting principles), the recommendations of the Task Force are subject to ultimate disposition by the Financial Accounting Standards Board. The recommendations are made for the purpose of urging the FASB to promulgate standards that the Task Force believes would be in the public interest.

Accounting Standards Task Force
on Investment Companies

James H. Muller, *Chairman*
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Edward L. Cameron
Phillip L. Cohen
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AICPA American Institute of Certified Public Accountants
1211 Avenue of the Americas, New York, New York 10036 (212) 575-6200

April 15, 1977

Marshall S. Armstrong, CPA
Chairman
Financial Accounting Standards Board
High Ridge Park
Stamford, Connecticut 06905

Dear Mr. Armstrong:

The accompanying Statement of Position of the Accounting Standards Division proposes changes to the AICPA Industry Audit Guide on Audits of Investment Companies to give effect to developments that have taken place since the Guide was published in 1973. It was prepared on behalf of the Division by the Accounting Standards Task Force on Investment Companies for consideration by the Financial Accounting Standards Board and for such action as the Board deems appropriate.

The Statement includes a section on money-market funds, which were not discussed specifically in the Guide. This section suggests reporting formats suitable for reporting the changes in net assets of money-market funds and provides guidance with respect to the presentation of the per-share data included in the financial statements as "Supplementary Information." In addition, the section contains recommendations on accounting and reporting for gains and losses on short-term investments.

The advent of listed options has increased trading volume significantly, and substantive procedural changes in the mechanics of the options market system have been codified and implemented. Accordingly, the Statement recommends that the sections of the Guide dealing with put and call options should be superseded. The Statement includes an expanded glossary, a discussion of industry practices, and recommendations on appropriate accounting and disclosure.

In recent years, a significant number of no-load funds, particularly money-market funds, have borne their own organization expenses. The Statement concludes, among other things, that expenses incurred by a newly organized open-end investment company in preparing its initial registration statement and obtaining clearance of such registration statement by the SEC should be considered part of its organization expense and accounted for as such. Expenses incurred after that registration statement has been declared effective by the SEC, such as printing a supply of prospectuses to be used for sales purposes, are not organization expenses. The Statement also contains recommendations with respect to the amortization of costs deferred by an investment company.

Finally, the Statement proposes an amendment to the discussion in the Guide of the valuation of short-term investments to make it clear that all investments, including short-term investments (money-market instruments), should be carried at amounts that approximate market or fair value.

Members of the Task Force will be glad to meet with you or your representatives to discuss this proposal. The Task Force would also appreciate being advised as to the Board's proposed action on the recommendations set forth in this Statement of Position.

Sincerely yours,

James H. Muller
Chairman
Accounting Standards Task Force on
Investment Companies

cc: Securities and Exchange Commission

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Introduction

The AICPA Industry Audit Guide, *Audits of Investment Companies,* notes that "changes in the rules, regulations, practices, and procedures of the investment company industry have been frequent and extensive in recent years" and that "further changes are under consideration." A number of changes and new developments have taken place since the Guide was published in 1973 which the Accounting Standards Division believes should be reflected in an amendment to the Guide.

This proposed amendment presents the Division's views on the following matters:

- Money-market funds (an addition to the Guide)
- Put and call options (supersedes discussion in the Guide)
- Expenses during the development stage (an addition to the Guide)
- Amortization of deferred costs (an addition to the Guide)
- Valuation of short-term investments (an amendment to the Guide)

The Guide includes collective trust funds within its general definition of investment companies, but has no discussion of regulatory and tax matters specifically applicable to such funds. Although collective trust funds are not investment companies within the definition of the Investment Company Act of 1940 and are not regulated under the Securities Acts, the accounting and auditing discussions in the Guide are applicable to such funds, where relevant. In addition, the auditor should be familiar with Regulation 9 of the Comptroller of the Currency, which is the regulatory standard for most collective funds operated by banks, and Subchapter H of the Internal Revenue Code, which contains rules for the specialized tax treatment of collective funds.

Money-Market Funds

Background

Money-market funds are open-end management investment companies that invest principally in money-market instruments (short-term government obligations, commercial paper, bankers' acceptances, certificates of deposit, and so forth) with the objective of preserving capital, maintaining liquidity, and obtaining current income. As such, money-market funds are subject to the provisions of the AICPA Industry Audit Guide, *Audits of Investment Companies.*

At the time the Guide was published in October 1973, only a few money-market funds were in operation, and the Guide did not discuss such funds specifically. However, many more have commenced operations since that date, and the Division believes that specific guidance for money-market funds is now desirable.

Distribution Policies

Many money-market funds declare dividends daily, thereby maintaining net asset value per share at or near a fixed amount, depending on which of the following distribution policies is adopted.

Distribution Policy	*Effect on Net Asset Value per Share*
(a) Define income for dividend purposes as the sum of net investment income, net realized gain (loss), and net unrealized appreciation (depreciation). If income, as defined, is a negative amount for any day, that amount is first offset against undistributed dividends accrued during the month in each	Net asset value remains fixed.

Distribution Policy	*Effect on Net Asset Value per Share*
shareholder's account. If a negative amount remains in a shareholder's account, outstanding shares are reduced by treating each such shareholder as having contributed shares to the fund to the extent of such negative amount.	
(b) Define income as in (a) above, but take no action for any day in which such income is a negative amount.	Net asset value remains fixed unless income, as defined, is a negative amount, in which case net asset value will be less than the fixed amount until restored to the fixed amount through subsequent income, as defined.
(c) Define income for dividend purposes as the sum of net investment income and net realized gain (loss).	Net asset value varies from the fixed amount to the extent of unrealized appreciation or depreciation. Also, it is reduced if income, as defined, is a negative amount that is not offset by unrealized appreciation (net realized loss exceeds net investment income and unrealized appreciation).
(d) Declare daily dividends from net investment income only; distribute net realized gain annually.	Net asset value varies from the fixed amount to the extent of the sum of undistributed realized gain (loss) and unrealized appreciation (depreciation).

Long-term capital gains, as defined in the Internal Revenue Code, may be distributed only once every 12 months unless a specific exemption is obtained.[1] Therefore, a fund that expects to

[1] Section 19(b) and Rule 19b-1 of the Investment Company Act of 1940.

realize long-term gains and that wishes to follow distribution policy (a), (b), or (c) will need to request exemption from Section 19(b) of the 1940 Act to avoid adverse consequences.

See page 19 of this Statement for a discussion of the valuation of short-term investments.

Statement of Changes in Net Assets

A modification of the format suggested in the Guide for the Statement of Changes in Net Assets is required to report clearly the effects of following one of the distribution policies described in (a), (b), or (c) in the preceding section.

A fund that follows distribution policy (a) or (b) should include a subtotal for net investment income and net realized gain (loss) and unrealized appreciation (depreciation) in the Statement of Changes in Net Assets. This subtotal represents income as defined for dividend purposes.

The following format is appropriate for the Statement of Changes in Net Assets (shown in part) of a money-market fund that has adopted distribution policy (a) or (b).

From Investment Activities	19X1	19X0
Net investment income	$100,000	$80,000
Net realized gain (loss) on investments	2,000	(1,000)
Increase (decrease) in unrealized appreciation of investments	(3,000)	1,000
Total available for distribution	$ 99,000	$80,000
Dividends declared	99,500	80,000
Decrease in assets derived from investment activities[2]	$ (500)	–

The following format is suggested for the Statement of Changes in Net Assets (shown in part) of a money-market fund that follows distribution policy (c); that is, it distributes the sum of net investment income and net realized gain or loss daily.

[2] A decrease in net assets derived from investment activities would be reported by a company following distribution policy (b) only if the company incurred a net loss (realized and unrealized) on investments that was not offset by net investment income and net gains (realized and unrealized) prior to the end of the reporting period.

From Investment Activities	19X1	19X0
Net investment income	$100,000	$80,000
Net realized gain (loss) on investments	2,000	(1,000)
Total available for distribution	$102,000	$79,000
Dividends declared	(102,000)	(79,000)
Increase (decrease) in unrealized appreciation of investments	(3,000)	1,000
Increase (decrease) in net assets derived from investment activities	$ (3,000)	$ 1,000

Money-market funds that follow distribution policy (d), or that do not declare dividends daily, should follow the presentation on page 101 of the Guide.

Supplementary Information

The per-share data included in the financial statements as "Supplementary Information" should be presented on a basis consistent with the presentation of the Statement of Changes in Net Assets, as illustrated or discussed above.[3] A fund that follows distribution policy (a) and that has treated each shareholder as having contributed shares to the fund when income, as defined, is a negative amount, should include an additional line item in the per-share data to show the effect of such action.

The investment policies of money-market funds are such that gains and losses, whether realized or unrealized, are usually incidental to the realization of investment income. Also, the dividend policy adopted by a fund should have no effect on the reported ratio of income to average net assets, because the purpose of the ratio is to indicate the effective rate of earnings, regardless of when the earnings are distributed. Accordingly, the most significant ratio for a money-market fund to report is the ratio of net investment income, plus or minus realized and unrealized gains or losses, to average daily net assets. When supplementary infor-

[3] Income (as defined) per share should be based on the per-share dividends declared during the period and prorated by components based on the amounts shown in the Statement of Operations. For example, a fund following distribution policy (a) or (b) would apportion its per-share income (as defined) between net investment income and realized and unrealized gain (loss).

mation is provided by a money-market fund, this ratio should be reported instead of the ratio of net investment income to average net assets, which is included in the illustration of "Supplementary Information" in the Guide.

It may be appropriate for a fund that distributes only net investment income (distribution policy (d)) to provide a breakdown of the ratio, in a footnote or parenthetically, indicating the portion applicable to realized and unrealized gains or losses, if they are significant.

When yield information is presented as "Supplementary Information" or elsewhere in the financial statements, a description of the method of computation should be provided.

Reporting Gains and Losses

When short-term investments, including discounted instruments, are sold prior to maturity, realized gains and losses should be recorded as such, based on the difference between the proceeds from sale and cost (amortized cost in the case of discounted instruments). However, net realized gains or losses are ordinarily not significant in relation to the total dollar amount of sales of money-market instruments. Further, such gains or losses are rarely significant in relation to the results of operations of a money-market fund. Accordingly, except in unusual circumstances, a money-market fund need not report the proceeds from sales and the cost of securities sold in the Statement of Operations; it need report therein only the amount of net realized gain or loss.

Changes in unrealized appreciation or depreciation should be reported following the presentation on page 100 of the Guide.

Federal Income Taxes

A fund that includes unrealized appreciation or depreciation in dividends may have distributed more or less than its taxable income in a particular year. Accordingly, a fund that follows such a policy should pay particular attention to the provisions of the Internal Revenue Code relating to the distribution of taxable income, as discussed more fully in chapter 5 of the Guide.

Put and Call Options

Background

An active public market has been developed in listed call options, and trading in listed put options is expected in early 1977. Although there has been an over-the-counter market in options for many years and the public has participated to some degree, the advent of listed options has increased trading volume significantly, and substantive procedural changes in the mechanics of the options market system have been codified and implemented. Accordingly, the Division believes that the sections of *Audits of Investment Companies* covering options should be amended to give appropriate guidance with respect to an investment company that purchases or sells options. This Statement of Position supersedes the following sections of the Guide:

- Valuation of Put and Call Options Purchased (chapter 3, "Investment Accounts," page 37)
- Valuation of Put and Call Option Contracts Written by the Investment Company (chapter 3, "Investment Accounts," page 38)
- Put and Call Options (chapter 5, "Taxes," page 69)

Option Trading

The following glossary of terms should be helpful in understanding the mechanics of option trading.

Exchange-Traded Option. A put or call option traded on an exchange and settled through the facilities of an exchange. It gives the buyer of the option ("holder") the right to sell to (put) or buy from (call) the seller ("writer") the number of shares or other units of the underlying security covered by the option at the stated exercise price prior to the fixed expiration date of the option. The designation of an option includes the underlying security, the expiration month, and the exercise price; for example, "XYZ July 50" means that a unit of trading (typically 100 shares) of XYZ stock may be sold or purchased at $50 per share until the option expires on the expiration date in July. Options of like designation are said to be of the same "series."

Underlying Security. The security subject to sale or purchase upon the exercise of the option.

Unit of Trading. The number of units of the underlying security designated as the subject of a single option. In the absense of any other designation, the unit of trading for a common stock is 100 shares.

Exercise Price. The price per share or other unit at which the holder of an option may sell or purchase the underlying security upon exercise. The exercise price is sometimes called the "striking price."

Expiration Date. The last day on which an option may be exercised.

Premium. The aggregate price of an option agreed upon between the buyer and writer or their agents.

Opening Purchase Transaction. A transaction in which an investor becomes the holder of an exchange-traded option.

Opening Sale Transaction. A transaction in which one becomes the writer of an exchange-traded option.

Closing Purchase Transaction. A transaction in which a writer of an exchange-traded option liquidates his position as a writer by "purchasing," in a transaction designated as a closing purchase transaction, an option having the same terms as the option previously written. Such a transaction has the effect, upon payment of the premium, of canceling the writer's pre-existing position instead of resulting in the issuance of an option.

Closing Sale Transaction. A transaction by which a holder of an option liquidates his position as a holder by "selling," in a transaction designated as a closing sale transaction, an option having the same terms as the option previously purchased. Such a transaction has the effect of liquidating the holder's pre-existing position instead of resulting in the holder's assuming the obligation of a writer.

Covered Writer. A writer of a call option who, as long as he remains a writer, owns the shares or other units of the underlying security covered by the option. The writer of a put is "covered" only when he purchases an option on the same underlying security with an exercise price equal to or greater than that of the option written.

Uncovered Writer. A writer of an option who is not a covered writer; sometimes referred to as "naked."

Option Writing

As consideration for the rights and obligations represented by an option, the buyer pays, and the writer receives, a premium. The premium is determined in the exchanges' option markets on the basis of supply and demand, reflecting factors such as the duration of the option, the difference between the exercise price and the market price of the underlying security, and the price volatility and other characteristics of the underlying security. A covered writer of a call option gives up, in return for the premium, the opportunity for profit from an increase in the price of the underlying security above the exercise price as long as the option obligation continues, but he retains the risk of loss should the price of the security decline. Since the option holder may exercise the option and purchase the securities at the designated price at any time prior to the expiration date of the option, the option writer has no control over the date of sale.

An uncovered writer of a call option assumes, in return for the premium, the obligation to provide the option holder with the underlying securities upon exercise of the option. The uncovered writer, therefore, may have a substantial risk of loss should the price of the security increase, but he has no risk of loss should the price of the security decrease.

As long as a secondary market in options remains available on each of the exchanges, the writer of an option traded on an exchange is able to liquidate his position prior to the exercise of such option by entering into a closing purchase transaction. Such a transaction has the effect of canceling the writer's pre-existing position. The cost of such a liquidating purchase, however, can be greater than the premium received upon writing the original option.

Because the purchaser or writer has the ability to enter into a closing transaction, the option originally written may never be exercised. The exercise of an exchange-traded option takes place only through the Options Clearing Corporation (OCC), which is the obligor on every option, by the timely submission of an exercise notice by the clearing broker acting on behalf of the exercising holder. The exercise notice is then "assigned" by the OCC to a clearing broker acting on behalf of a writer of an option of the same series as the exercised option. This broker is then obligated to deliver the underlying security against payment of the aggregate exercise price. The assigned broker is randomly selected from clearing members having accounts with the OCC with options outstanding of the same series as the option being exercised.

Most investment companies deposit securities underlying the options written in order to guarantee delivery in the event the option is exercised.

Accounting

Portfolio securities underlying call options should be reported at value, determined in accordance with the provisions of the Guide, and reflected in net asset value accordingly. Premiums received by an investment company from the sale of outstanding call options should be included in the liability section of the Statement of Assets and Liabilities as a deferred credit and subsequently adjusted to the current market value (marked-to-market) of the option written. For example, if the current market value of the option exceeded the premium received (which should be shown parenthetically in the Statement of Assets and Liabilities), the excess would be an unrealized loss and, conversely, if the premium exceeded the current market value, such excess would be an unrealized gain. Current market value of exchange-traded options should be the last sales price or, in the absence of a transaction, the mean between the closing bid and ask prices, or the ask prices, in accordance with the valuation policy followed by the fund. The change in unrealized depreciation or appreciation resulting from the mark-to-market may be included with unrealized gains or losses on the portfolio in the Statement of Operations and Statement of Changes in Net Assets, with disclosure as to the amount, or it may be reported as a separate line item.

With respect to covered options, disclosure, summarized by security, should be made of the description and number of shares of portfolio securities covering outstanding options and the market value of the options. Disclosure should also be made of the aggregate market value of the securities or other assets deposited as collateral. With respect to uncovered options, disclosure should be made of the description and quantity of securities under option, the expiration dates and exercise prices, the current market prices of the securities covered by the options, and the assets deposited in escrow with respect to such options.

Subsequent to the sale of a call option, any one of three events may occur: the option may expire on its stipulated expiration date; the writer may enter into a closing transaction; or the option holder may exercise his right to call the security. Either of the first two events results in a realized gain (or loss if the cost of the closing transaction exceeds the premium received when the option was sold) for the investment company option writer and should be accounted for as such. The third possible event results, in the case of a covered writer, in the sale of the underlying securities, unless the writer purchases like securities for delivery to the exercising holder. The proceeds should be increased by the amount of premium originally received, and realized gains or losses resulting from such sales should be accounted for in the conventional manner. If an uncovered option is exercised, the writer must purchase the underlying securities in order to meet his obligation to the option holder. In such situations, the writer's realized loss resulting from the simultaneous purchase and sale of the securities should be reduced by the premium originally received, and the net realized loss (or gain) should be accounted for in the conventional manner.

The foregoing describes the accounting for the sale of call options. The same principles are applicable to the sale of put options.

Actively traded put and call options purchased by an investment company should be accounted for in the same manner as marketable portfolio securities. The cost of portfolio securities acquired through the exercise of call options should be increased by the premium paid to purchase the call. The proceeds from securities sold through the exercise of put options should be decreased by the premium paid to purchase the put.

Transactions in options not listed on a national exchange or not actively traded should be accounted for as described in the foregoing paragraphs, except that the determination of unrealized gain or loss during the contract period of the option must be based on the fair value of the option as determined by the investment company's board of directors. Among the many factors to be considered in the determination of fair value are the price of the underlying securities, the liquidity of the market, and the time remaining prior to expiration date.

Federal Income Taxes

The following paragraphs are intended to supersede only that portion of chapter 5 of the Guide ("Taxes") dealing with put and call options. Reference to that chapter should be made for other information pertinent to the taxation of investment companies.

For federal income tax purposes, premium income from the sale of options is deferred until expiration or exercise of the option, or until a closing purchase transaction takes place. If the option expires, the premium constitutes a short-term capital gain. If the option is exercised and the underlying securities are sold, the premium is added to the proceeds from the sale of the securities in determining capital gain or loss. Such gain or loss is short-term or long-term depending upon the holding period of the underlying securities. If the option is closed in a closing purchase transaction, the difference between the amount paid for the option purchased and the premium received on the original sale is a short-term capital gain or loss.[4]

Under the Internal Revenue Code, an investment company cannot qualify as a regulated investment company unless, among other things, less than 30 percent of its gross income is derived from gains from the sale or other disposition of securities held for less than three months ("30 percent rule"). Therefore, in order to be taxable as a regulated investment company, its ability to write

[4] The termination of a writing position that was established on or before September 1, 1976, by lapse of the option or by a closing purchase transaction, will produce ordinary income or loss.

options with exercise periods of less than three months or to effect closing purchase transactions within three months of writing options is restricted. For purposes of meeting this "three-month test," the holding period for the sale of an option commences on the day it is written.

An investment company must derive at least 90 percent of its gross income from dividends, interest, and gain from the sale or other disposition of stock or securities ("investment income"), in order to qualify as a regulated investment company in any taxable year. For tax purposes, income received from expired call options and from profits in executing closing purchase transactions for amounts less than the call premiums received qualifies as investment income.

Expenses During the Development Stage

The standards of financial accounting and reporting set forth in FASB Statement No. 7, *Accounting and Reporting by Development Stage Enterprises,* are applicable to financial statements issued by investment companies that are in the development stage, as defined in the FASB Statement. The following paragraphs in this section discuss certain expenses that may be incurred by an investment company that is in the development stage.

A newly formed investment company will incur organization expenses unless it is sponsored by a management company that has agreed to absorb these expenses. Organization expenses consist of expenses incurred in order to establish the company and legally equip it to engage in business. In recent years, a significant number of no-load funds, particularly money-market funds, have borne their own organization expenses.

An open-end investment company, which is organized to offer shares of capital stock to the public continuously and to invest the proceeds from sale of such capital stock, cannot be considered to be organized until it has registered securities with the Securities and Exchange Commission. Therefore, expenses incurred by a newly organized open-end investment company in preparing its initial registration statement and obtaining clearance of such registration statement by the SEC should be considered part of its organization expenses; expenses incurred after that registration statement has been declared effective by the SEC, such as printing a supply of prospectuses to be used for sales purposes, are not organization expenses.

As stated in *Audits of Investment Companies*, "closed-end companies charge all registration fees against paid-in capital at the time the shares are sold." This Statement of Position does not modify that requirement.

Once an investment company has been organized to do business, it usually engages immediately in its planned principal operations, that is, sales of capital stock and investment of funds. The training of employees, development of markets for the sale of capital stock, and similar activities are usually performed by the investment adviser or other agent, and in such cases the costs of these activities are not borne directly by the investment company. However, an investment company (particularly one that does not employ agents to manage its portfolio and perform other essential functions) may engage for a period of time in such activities, and may bear those costs directly during its development stage.

As stated above, an investment company that is in the development stage is subject to the provisions of FASB Statement No. 7. Paragraph 10 of the FASB Statement notes that "generally accepted accounting principles that apply to established operating enterprises . . . shall determine whether a cost incurred by a development stage enterprise is to be charged to expense when incurred or is to be capitalized or deferred." Accordingly, the costs and expenses discussed in the preceding paragraphs should be accounted for in accordance with the generally accepted accounting principles that apply to established operating enterprises. Organization expenses of investment companies are usually deferred and amortized in financial statements prepared in conformity with generally accepted accounting principles.

Amortization of Deferred Costs

Costs deferred by an investment company should be subject to the same assessment of recoverability that would be applicable to any established operating company. Such costs should be amortized to income over the period during which it is expected that a benefit will be realized. That period may vary according to the type of expense. Several costs are listed below.

Organization Expenses. Generally such expenses are amortized over a period of not more than 60 months from the date of commencement of operations. Straight-line or other acceptable methods of amortization may be utilized.

If such expenses are amortized on the basis of assets expected to be managed over the period selected, the projected growth rate initially used as the basis for establishing an amortization table should be reviewed frequently and adjusted, if necessary, to reflect actual experience.

Cost of Printing Prospectuses. Costs deferred in connection with printing a supply of prospectuses for sales purposes should be amortized, generally on a straight-line basis, over the period during which the prospectus may be used, which is limited to a period ending 16 months after the date of the latest audited financial statements. If during this period it becomes evident that the prospectus will be effective for a shorter period than originally anticipated, amortization should be accelerated so that no costs remain deferred at the end of such shorter period.

Registration Fees. Deferred SEC and state registration fees should be written off as the registered shares of stock are sold (but over not more than 60 months).

The summary in the financial statements describing an investment company's significant accounting policies should cover the company's accounting for deferred costs.

Valuation of Short-Term Investments

The discusssion of the valuation of short-term investments on page 39 of the Guide states that "original cost plus amortized discount or accrued interest . . . usually approximates market value." This statement was made when holdings of short-term investments generally constituted a small portion of an investment company's portfolio. It was not intended to modify the principle that "all investment companies should report their securities portfolio at value." In all cases, the board of directors should be satisfied that investments, including short-term investments (money-market instruments), are carried at amounts that approximate market or fair value. Accordingly, the Division believes that the discussion entitled Short-Term Investments on page 39 of the Guide should be amended by the addition of the following paragraph:

> Although the amortized cost of money-market instruments that mature within a relatively short period of time ordinarily approximates market value, it must be recognized that unusual events, such as the impairment of the credit standing of the issuer, can significantly affect the value of short-term investments regardless of the number of days to maturity. Changes in interest rates can also have a significant effect on the value of money-market instruments with longer terms to maturity. In such cases, amortized cost might not approximate the value of these investments. When amortized cost does not approximate value, the investments should be valued on the basis of quoted sales prices, bid and asked prices, or fair value based upon appraisals furnished by market makers or other appropriate evidence.